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### **Acronyms**

CFR	Code of Federal Regulations
DFARS	Defense Federal Acquisition Regulation Supplement
FAR	Federal Acquisition Regulation
GAO	Government Accountability Office
IDIQ	Indefinite-Delivery, Indefinite-Quantity
IT	Information Technology
ITEC4	Information Technology, E-Commerce, and Commercial Contracting Center
ITES-2H	Information Technology Enterprise Solutions-2 Hardware
ITES-2S	Information Technology Enterprise Solutions-2 Services
ITES-EMS3	Information Technology Enterprise Solutions-Enterprise Mission Support Services Solutions
NAICS	North American Industry Classification System
SBA	Small Business Administration
SIC	Standard Industrial Classification



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202-4704

August 9, 2007

MEMORANDUM FOR AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Report on Army Information Technology Enterprise Solutions-2 Services  
Contract (Report No. D-2007-115)

We are providing this report for review and comment. We considered management comments on a draft of this report in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. As a result of management comments, we revised Recommendation 1.c. Therefore, we request that the Assistant Secretary of the Army (Acquisition, Logistics, and Technology) provide comments on Recommendations 1.a., 1.b., and 1.c. by September 9, 2007.

If possible, please send management comments in electronic format (Adobe Acrobat file only) to [AudACM@dodig.mil](mailto:AudACM@dodig.mil). Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. If you arrange to send classified comments electronically, they must be sent over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Questions should be directed to Ms. Jacqueline L. Wicecarver at (703) 604-9077 (DSN 664-9077) or Mr. Sean A. Davis at (703) 604-9049 (DSN 664-9049). See Appendix C for the report distribution. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

A handwritten signature in black ink, reading "Richard B. Jolliffe".

Richard B. Jolliffe  
Assistant Inspector General  
Acquisition and Contract Management

## Department of Defense Office of Inspector General

**Report No. D-2007-115**

**August 9, 2007**

(Project No. D2006-D000AS-0173.000)

### **Army Information Technology Enterprise Solutions-2 Services Contract**

#### **Executive Summary**

**Who Should Read This Report and Why?** Contracting personnel from the Army and other Federal agencies who are involved in information technology service acquisition decisions should read this report because it provides an assessment of how the Army can improve small business participation in indefinite-delivery, indefinite-quantity (IDIQ) contracts.

**Background.** We initiated the audit of the Army Information Technology Enterprise Solutions-2 Services (ITES-2S) contract because of the material impact this contract will have on the acquisition of information technology resources within DoD and the Federal Government. According to the Army Information Technology, E-Commerce, and Commercial Contracting Center, the ITES-2S contract is a follow-on to its Information Technology Enterprise Solutions-Enterprise Mission Support Services Solutions IDIQ contract. The ITES-2S contract has a ceiling price of \$20 billion. The contract has a 3-year base period with three 2-year option periods. The purpose of the ITES-2S contract is to support the Army enterprise infrastructure and infostructure goals with information technology services worldwide. The U.S. Army, DoD, and all other Federal agencies will be authorized to fulfill requirements under the ITES-2S contract.

**Results.** The Army Information Technology, E-Commerce, and Commercial Contracting Center contracting officials did not justify consolidating contract requirements for the \$20 billion ITES-2S contract. Additionally, the officials selected an inappropriate North American Industry Classification System (NAICS) code in the solicitation of the contract. As a result, ITES-2S is a bundled contract that improperly restricted small business competition and was unsuitable for small business award. Bundling a contract without justification violates United States Code and Federal regulations. (See the Finding section of the report for the detailed recommendations.) The Army Contracting Agency internal controls were not adequate. We identified material internal control weaknesses on the adherence of the ITES-2S contract NAICS code to the Federal Acquisition Regulation requirements.

In a memorandum, "Information Technology Enterprise Solutions-2 Services Contract," December 8, 2006, we requested that the Assistant Secretary of the Army for Acquisition, Logistics, and Technology halt all ITES-2S contracting activity and future task orders until after the problems identified in this report are resolved.

**Management Comments and Audit Response.** We received comments from the Assistant Secretary of the Army for Acquisition, Logistics, and Technology who responded on behalf of the Director, Army Contracting Agency. He nonconcurred based on the broad scope of the ITES-2S requirements, the nature of the work performed, the

pre-approval of the NAICS code, and small business participation. Specifically, the Assistant Secretary stated that selecting a NAICS code based on the procedures outlined in Federal Acquisition Regulation 19.102, "Size Standards," poses a challenge for IDIQ contract vehicles because of the extremely broad scope and the fact that there are no definitized requirements until task orders are issued. He stated the contracting officer considered the nature of work and contended that the type of work to be performed is not the only consideration and quoted Title 13 Code of Federal Regulations Section 121.402(b) (2006), "Size Eligibility Requirements for Government Procurement." In addition, he stated that the NAICS code 517110 was approved by the U.S. Army and DoD Small and Disadvantaged Business Utilization offices and the Small Business Administration. The Assistant Secretary stated that the selected code did not preclude smaller businesses from submitting proposals.

In response, we stated that the use of an IDIQ contract requires the contracting officer to identify a recurring need. If the contracting officer could not reasonably describe the types of services or supplies she was intending to acquire under ITES-2S, then this type of contract should not have been utilized. The contracting officer may have considered the nature of work when selecting the NAICS code, but ultimately her deductions were incorrect when selecting the NAICS code. The primary factors for selecting a NAICS code are the principal purpose of the products or services being acquired and the products or services accounting for the greatest percentage of the contract price. We do not believe these approvals prove a correct NAICS code was selected. NAICS code 517110 has the largest size standard allowed by the Small Business Administration, and no income limitation is placed on NAICS code 517110. Therefore, businesses receiving up to approximately \$700 million in yearly revenue can qualify as a small business under NAICS code 517110.

The Assistant Secretary nonconcurred and stated that specific requirements have not been pre-defined under ITES-2S, requirements are performed at the task order level, the acquisition plan was approved, information technology services were not consolidated, and small businesses were not deprived of participation. Specifically, he stated that ITES-2S is an IDIQ vehicle with no specific, pre-defined requirements; therefore, a consolidation justification is not required by Defense Federal Acquisition Regulation Supplement 207.170-2, "Definitions," at the contract level. In response, we stated that Defense Federal Acquisition Regulation Supplement 207.170, "Consolidation of Contract Requirements," is clearly applicable to the ITES-2S acquisition. Multiple-award task order contracts, to include ITES-2S, fall under the scope of Defense Federal Acquisition Regulation Supplement 207.170.

The Assistant Secretary nonconcurred and disagreed because the ITES-2S contract is not consolidated, bundling determination applies at the task order level, the Government Accountability Office Competition and Contracting Act rulings justify consolidation, and small businesses did not receive a competitive disadvantage. Specifically, the Assistant Secretary contended that ITES-2S is not a bundled contract because ITES-2S does not consolidate contract requirements. However, we stated that Defense Federal Acquisition Regulation Supplement 207.170, "Consolidation of Contract Requirements," is applicable; therefore, the ITES-2S contract does constitute consolidation.

Based on management comments, we revised the recommendation regarding re-competing the ITES-2S contract or justifying the contract bundling if small business participation is not warranted at the prime contract level. It was revised because it is no longer reasonable for the U.S Army to re-compete the ITES-2S base contract.



The Assistant Secretary of the Army for Acquisition, Logistics, and Technology concurred with the recommendation that the Director, Army Small and Disadvantaged Business Utilization develop a standardized contract review process for small business that verifies compliance with the Federal Acquisition Regulation requirements. The comments were responsive to the recommendation.

We request that the Assistant Secretary of the Army for Acquisition, Logistics, and Technology provide comments on the revised recommendation in response to the final report by September 9, 2007. See the Finding section of the report for a discussion of management comments on the recommendations and the Management Comments section of the report for the complete text of the comments.

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## Background

We initiated the audit of the Army Information Technology Enterprise Solutions-2 Services (ITES-2S) contract because of the material impact this contract will have on the acquisition of information technology (IT) resources within DoD and the Federal government. The ITES-2S contract is a multiple-award, indefinite-delivery, indefinite-quantity (IDIQ) contract. The ceiling of the ITES-2S contract is \$20 billion over a 9-year period, which includes a 3-year base period and three 2-year option periods. According to contracting personnel, the ITES-2S acquisition will replace the Army's Information Technology Enterprise Solutions-Enterprise Mission Support Services Solutions (ITES-EMS3) contract, which is approaching its ceiling of \$500 million. The ITES-2S contract will be available to all DoD and Federal agencies.

**Contract Management.** Army Contracting Agency, Information Technology E-Commerce and Commercial Contracting Center (ITEC4) originally awarded the ITES-2S contract on April 14, 2006, to 11 contractors, consisting of 8 large businesses and 3 small businesses. The eight large businesses included: Booz Allen Hamilton, Incorporated; CACI International, Incorporated; Computer Sciences Corporation; EDS Corporation; General Dynamics Corporation; IBM Corporation; Lockheed Martin Corporation; and Science Applications International Corporation. The three small businesses included: Apptis, Incorporated; STG, Incorporated; and QSS Group, Incorporated. The Army Small Computer Program and Program Executive Office-Enterprise Information System manage the ITES-2S contract.

**Government Accountability Office Protests.** On May 5, 2006, five businesses (Multimax, Incorporated; NCI Information Systems, Incorporated; BAE Systems Information Technology LLC; Northrop Grumman Information Technology, Incorporated; and Pragmatics, Incorporated) filed formal protests with the Government Accountability Office (GAO). The Army advised GAO that they failed to account for all information received during discussions with the contractors when evaluating performance risk. As a result, the Army withdrew the awards and GAO dismissed the protests on May 12, 2006. Army officials reviewed the awards and re-awarded the contract to the initial 11 contract winners on July 13, 2006. After the contract was re-awarded, the same five businesses filed a second round of protests with GAO in July 2006 on the basis of unreasonable evaluation of labor rates and inadequate discussions. In October 2006, GAO sided with the five protestors and recommended that the Army reopen discussions with the protestors and request revised proposals. Additionally, GAO recommended that the five protestors be reimbursed for their costs of filing and pursuing their protests, including reasonable attorney's fees. In November 2006, the Army settled with the five businesses by allowing these businesses to join the contract as prime contractors.

**Contract Scope.** ITES-2S is a multiple-award, task order contract intended to support the Army enterprise infrastructure and infostructure goals with IT services worldwide. The scope of the contract encompasses all requirements for IT service solutions; telecommunication and net-centric enterprise management requirements not covered by Installation Information Infrastructure

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Modernization Program and Command, Control, Communications, Computers, and Information Management requirements; and related hardware and software required to provide complete end-to-end solutions. ITES-2S will also satisfy worldwide development, deployment, operation, maintenance, and sustainment requirements for the Army. This contract is intended to provide IT excellence through IT services and related equipment that meet the automation needs of the Army and other customers.

**Interim Audit Results.** In a memorandum, “Information Technology Enterprise Solutions-2 Services Contract,” December 8, 2006, we requested that the Assistant Secretary of the Army for Acquisition, Logistics, and Technology (Assistant Secretary) halt all ITES-2S contracting activity and future task order awards until after the problems identified in this report are resolved. The contracting office had awarded 11 contracts on April 14, 2006, and was in the process of awarding additional contracts when we drafted the memorandum. On December 4, 2006, prior to receiving our December 8, 2006, memorandum, the contracting office awarded 5 additional contracts.

## Objective

Our overall audit objective was to review the acquisition of the ITES-2S contract valued at \$20 billion. Specifically, we determined whether the acquisition was consistent with Federal and DoD acquisition and contracting policy, to include information assurance requirements. We determined that the ITES-2S contract met all Federal Government and DoD Information Assurance requirements. See Appendix A for further discussion of information assurance and for a discussion of the scope and methodology. See the Finding for a discussion of the ITES-2S contract acquisition.

## Review of Internal Controls

We identified material internal control weaknesses for the Army’s ITES-2S contract as defined by DoD Instruction 5010.40, “Managers’ Internal Control (MIC) Program Procedures,” January 4, 2006. DoD Instruction 5010.40 states that internal controls are the organization, policies, and procedures that help program and financial managers to achieve results and safeguard the integrity of their programs. The Army Contracting Agency did not have procedures in place to ensure the ITES-2S contract was assigned a North American Industry Classification System (NAICS) code that best describes the principal nature of the services to be acquired, as required by the Federal Acquisition Regulation (FAR). Implementing recommendations 1.a., 1.b., and 1.c. will improve the ITES-2S contract by allowing proper small business participation. A copy of the final report will be provided to the senior official responsible for internal controls for the ITES-2S contract.

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## Small Business Participation

Army ITEC4 contracting officials did not justify consolidating contract requirements for the \$20 billion ITES-2S contract. Additionally, the officials selected an inappropriate NAICS code in the solicitation of the contract. These conditions occurred because ITEC4 contracting officials did not comply with Defense Federal Acquisition Regulation Supplement (DFARS) procedures for consolidating contract requirements and did not comply with FAR procedures in assigning an appropriate NAICS code in the solicitation. As a result, the ITES-2S is a bundled contract that improperly restricted small business competition and was unsuitable for small business award.

## Contract Consolidation Policy

**United States Code.** Section 2382, title 10, United States Code, (10 U.S.C. 2382), states that the Secretary of Defense shall require the Secretary of each Military Department to ensure that the decisions made in regard to the consolidation of contract requirements are made with a view to provide small business concerns with appropriate opportunities to participate in DoD procurements as prime contractors and appropriate opportunities to participate in such procurements as subcontractors.

**Defense Federal Acquisition Regulation Supplement.** DFARS Section 207.170, “Consolidation of Contract Requirements,” implements 10 U.S.C. 2382. DFARS 207.170 defines “consolidation of contract requirements” as the

use of a solicitation to obtain offers for a single contract or a multiple award contract to satisfy two or more requirements of a department, agency, or activity for supplies or services that previously have been provided to, or performed for, that department, agency, or activity under two or more separate contracts.

The DFARS states that “agencies shall not consolidate contract requirements with an estimated total value exceeding \$5.5 million unless the acquisition strategy includes—

- (1) The results of market research;
- (2) Identification of any alternative contracting approaches that would involve a lesser degree of consolidation; and
- (3) A determination by the senior procurement executive that the consolidation is necessary and justified.”

**Deputy Secretary of Defense Memorandum.** A memorandum signed by the Deputy Secretary of Defense, “Consolidation of Contract Requirements,” October 28, 1996, states that when planning for the consolidation of several

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contracts or requirements into a single larger contract, consideration must be given to the impact on small businesses, small disadvantaged businesses, and small women-owned businesses. The memorandum further states that requirements should be packaged so as not to preclude performance by small, small disadvantaged, and small women-owned business concerns as prime contractors unless the consolidation will result in significant benefits in terms of reduced life cycle costs, improved services, or both, and any such determination should be supported by market research analysis.

## Consolidation of Contract Requirements

ITEC4 contracting officials did not justify consolidating contract requirements in the preparation of the ITES-2S contract. ITES-2S is a \$20 billion multiple-award contract that will satisfy multiple requirements for IT services that have previously been provided to the Army under separate smaller contracts.

**ITES-2S Contract Proposal.** The purpose of ITES-2S is to support the Army enterprise infrastructure and infostructure goals with IT services worldwide, and the scope encompasses all requirements for IT service solutions. The acquisition plan states that it is the intention of the Government to establish a scope that is broad, sufficiently flexible to satisfy requirements that may change over the period of performance, and fully comprehensive so as to embrace the full complement of services that relate to IT. The ITES-2S scope of work categorizes IT service solutions into task and sub-task areas. Nine task areas and over 80 sub-task areas are listed. Additionally, according to the ITES-2S solicitation, the list is not all inclusive and additional sub-task areas can be added when task orders are issued. One requirement cannot encompass worldwide IT service solutions that include a broad range of task and sub-task areas. Furthermore, the acquisition plan and solicitation frequently use the plural word “requirements” and not the singular word “requirement” when referring to what is to be acquired under ITES-2S.

**Previous Contract.** ITEC4 contracting officials stated that ITES-2S is a replacement for ITES-EMS3 and the requirements for ITES-2S are substantially the same as for ITES-EMS3. However, there are significant differences between the two contracts in terms of ceiling price and volume of task areas.

- The ITES-EMS3 contract has a \$500 million ceiling, whereas the ITES-2S has a \$20 billion ceiling.
- The ITES-EMS3 solicitation contains 14 task areas and no sub-task areas, whereas the ITES-2S solicitation contains a total of 95 task and sub-task areas.

Therefore, the ITES-2S requirements are different from the ITES-EMS3 requirements, and contracting officials should have reviewed other Army contracting actions to determine whether ITES-2S consolidated the requirements previously provided under separate smaller contracts.

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Although ITES-EMS3 did not specifically fall within the scope of this audit, it could have also consolidated requirements. Therefore, the ITEC4 contracting officials cannot avoid consolidation consideration just because they consider ITES-2S a follow-on contract to the ITES-EMS3.

**Contract Requirements on Other Army Contracts.** We identified Army solicitations for IT services by using the search engine within FedBizOpps.<sup>1</sup> Our search results identified hundreds of Army solicitation notices from March 2004 through February 2007 that solicited for IT services that were within the scope of the ITES-2S contract. Therefore, the Army was satisfying multiple requirements for IT services through separate smaller contracts. Many of these requirements for IT services that were previously provided to the Army are now consolidated under ITES-2S.

## **Justification for Contract Consolidation**

The ITES-2S acquisition plan states that the ITES-2S procurement does not involve consolidating requirements. In addition, the plan states that “no requirements have been identified for performance under ITES-2S to satisfy two or more requirements for an activity that were previously performed for the activity under two or more separate contracts lower in cost than the total cost estimated for ITES-2S.” However, we determined that ITES-2S consists of multiple requirements and has consolidated these requirements under one contracting vehicle.

Contracting officials did not follow DFARS procedures by consolidating contract requirements without conducting market research to determine whether the consolidation was necessary and justified. DFARS states that market research may indicate that consolidation of contract requirements is necessary and justified if the benefits of the acquisition strategy substantially exceed the benefits of each of the possible alternative contracting approaches. ITEC4 contracting officials did not identify alternative contracting approaches that involved a lesser degree of consolidation and did not perform a benefit analysis to determine whether consolidation would result in significant benefits. Additionally, ITEC4 contracting officials did not identify significant benefits the Army would receive in consolidating requirements as opposed to utilizing alternative approaches. Furthermore, DFARS 207.170-3, “Policy and Procedures,” requires that the Army senior procurement executive review and determine whether contract consolidation is necessary and justified. The ITEC4 contracting officials did not request that the senior procurement executive determine that the consolidation was necessary and justified for ITES-2S.

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<sup>1</sup> FedBizOpps is the single Government on-line point-of-entry for Federal Government procurement opportunities over \$25,000. Government buyers are able to publicize their business opportunities by posting information directly to FedBizOpps via the Internet.

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## NAICS and Size Standards Background

**Small Business Codes and Size Standards.** The NAICS is used in the classification of business establishments. The system was developed for the United States, Canada, and Mexico, the three countries that participate in the North American Free Trade Agreement. In classifying nearly 1,200 industries, the NAICS provides Government and business analysts the ability to directly compare industrial production statistics collected and published across the three countries.

The Small Business Administration (SBA), as mandated in the Small Business Act, establishes the numerical definition of small business on an industry-by-industry basis. The numerical definition is referred to as a “size standard” and is stated in either number of employees or average annual receipts. The SBA assigns size standards to each of the industries identified in the NAICS. The size standards define the maximum size a business can be within an industry and still be considered a small business. According to the “Guide to SBA’s Definitions of Small Business,” contracting officers will designate, as part of solicitations, the NAICS code and corresponding size standard that represents the goods or services being procured.

**Size Standard Policy.** The Code of Federal Regulations (13 C.F.R. Part 121), “Small Business Size Regulations,” (2006) states that the SBA size standards define whether a business entity is small, and thus, eligible for Government programs and preferences reserved for small business concerns. Further, the regulation states that a concern must not exceed the size standard for the NAICS code specified in the solicitation. The procuring agency contracting officer should designate the NAICS code that best describes the principal purpose of the product or service being acquired. A procurement should be classified according to the component that accounts for the greatest percentage of contract value.

FAR Subpart 19.102, “Size Standards,” prescribes policies and procedures for identifying the NAICS code and the correlating size standard for the services being acquired. The FAR states that small business size standards are applied by classifying the product or service being acquired in the industry, whose definition, as found in the NAICS manual, best describes the principal nature of the product or service being acquired. In addition, the FAR states that for size standard purposes, a product or service shall be classified in only one industry, whose definition best describes the principal nature of the product or service being acquired even though for other purposes it could be classified in more than one. Further, the FAR states that when acquiring a service that could be classified in two or more industries with different size standards, contracting officers shall apply the size standard for the industry accounting for the greatest percentage of the contract price.

**Government-Wide Small Business Goals.** The Government-wide small business prime contracting goal is 23 percent (as cited in 15 U.S.C. 644). Therefore, as mandated by law, Government agencies must strive to award 23 percent of all prime contracting dollars to small businesses.

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## ITES-2S Contract Award

Army's ITEC4 contracting officials did not properly consider appropriate small businesses for participation in the \$20 billion ITES-2S contract award. The FAR states that the size standard is assigned by classifying the services being acquired in the industry that best describes those services. ITES-2S is for the acquisition of IT services, but instead of selecting a NAICS code that describes an industry that performs IT services, contracting officials selected a NAICS code that describes an industry that performs the functions of a telephone company.

The ITES-2S scope encompasses all requirements for IT service solutions, including a wide range of tasks pertaining to IT services. The acquisition plan states that the ITES-2S contract is predominately for services, with incidental hardware and software. The Army Small Computer Program office is currently soliciting a separate contract, Information Technology Enterprise Solutions-2 Hardware (ITES-2H), to acquire hardware in support of Army requirements. (See Appendix B for Other Matters of Interest on this contract).

**NAICS Code Comparisons.** The Independent Government Cost Estimate prepared by ITEC4 officials lists the labor categories associated with the ITES-2S contract, as well as the estimated dollars to be spent over the life of the contract for each of these labor categories. The vast majority of the labor categories and estimated associated costs were in some degree related to IT services. For example, the labor categories are organized in the following sections:

- program and project management,
- quality assurance,
- IT systems architecture,
- application systems,
- operations and logistics,
- information assurance,
- system administration,
- data administration,
- data warehousing,
- help desk/end user support,
- Internet/Web operations,
- network administration/support,
- documentation,
- enterprise resource planning/business process development, and
- information systems training.

Additionally, the task areas listed in the ITES-2S statement of objectives are:

- business process reengineering;
- information systems security;
- information assurance;
- IT services;
- enterprise design, integration, and consolidation;
- education/training;



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- program/project management;
  - systems operation and maintenance; and
  - network support.

Conversely, the contracting officials solicited the ITES-2S contract under NAICS code 517110, “Wired Telecommunications Carriers.” The NAICS manual defines “Wired Telecommunications Carriers” as the industry engaged in operating and maintaining switching and transmission facilities to provide point-to-point communications via landlines, microwave, or a combination of landlines and satellite linkups or furnishing telegraph and other non-vocal communications using their own facilities. Corresponding index entries included with the NAICS definition of “Wired Telecommunications Carriers” are:

- facilities-based telecommunication carriers (except wireless);
- local telephone carriers (except wireless);
- long-distance telephone carriers (except wireless);
- telecommunications carriers, wired;
- telecommunications networks, wired;
- telegram services (except wireless);
- telephone carriers, facilities-based (except wireless); and
- telephone installation by telecommunications carriers, wired.

The definition and corresponding index entries for the NAICS code assigned to the ITES-2S contract by contracting officials pertain to activities associated with telephone companies such as AT&T, which focus on providing telecommunications and local and long-distance telephone service.

**NAICS Sub-Sector 541.** The NAICS manual contains other codes that better describe the services being acquired under the ITES-2S contract. ITEC4 officials stated that ITES-2S will be used to acquire skills and expertise in the field of IT services. Similarly, NAICS sub-sector 541, “Professional, Scientific, and Technical Services,” contains codes that reflect industries that have production processes that are almost wholly dependent on worker skills. Further, the definition of sub-sector 541 states that in most of these industries, equipment and materials are not of major importance; instead, these industries sell expertise. Specifically, IT services are classified under NAICS section 54151, “Computer Systems Design and Related Services.” NAICS section 54151 is defined as the industry that is composed of establishments primarily engaged in providing expertise in the field of IT through one or more of the following activities:

- writing, modifying, testing, and supporting software to meet the needs of a particular customer;
- planning and designing computer systems that integrate computer hardware, software, and communication technologies;
- on-site management and operation of clients’ computer systems and/or data processing facilities; and
- other professional and technical computer-related advice and services.

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NAICS section 54151 best describes IT services; a code within this section would best represent the industry accounting for the greatest percentage of contract price. The following four codes are contained in NAICS sub-sector 541 under section 54151:

- 541511, “Custom Computer Programming Services;”
- 541512, “Computer Systems Design Services;”
- 541513, “Computer Facilities Management Services;” and
- 541519, “Other Computer Related Services.”

The small business size standards associated with each of the above NAICS codes limit the average total annual income of a qualifying small business to \$23 million. Therefore, according to the SBA, any business that over the past 3 years averages more than \$23 million in total receipts would not qualify as a small business under these NAICS codes.

In contrast, the NAICS code selected by the contracting officials for the ITES-2S contract had an associated small business size standard that limited qualifying small businesses to 1,500 employees. In assigning NAICS code 517110 to the ITES-2S solicitation, contractors were able to compete for small business reserves with no regard to income limitations. This resulted in the selection of the following three contractors in the initial ITES-2S small business reserve<sup>2</sup> award:

- Apptis, Inc., with approximately 1,480 employees and 2005 revenue of approximately \$700 million;
- STG, Inc., with approximately 1,200 employees and 2005 revenue of approximately \$170 million; and
- QSS Group, Inc., with approximately 1,400 employees and 2005 revenue of approximately \$282 million. However, QSS Group, Inc., was recently acquired by Perot Systems, which has more than 20,000 associates and had annual revenue of \$2 billion in 2005. This should impact its small business qualification status.

Businesses that qualify as being small under NAICS section 54151 best meet the definition of the services to be acquired under the ITES-2S contract. However, as a result of contracting officials assigning a NAICS code that describes an industry unrelated to the ITES-2S contract, inappropriate small businesses were awarded prime contracts.

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<sup>2</sup> The ITES-2S acquisition was conducted under a full and open competition but up to four awards were reserved for small businesses. STG, Inc., and QSS Group, Inc., were awarded contracts reserved for small businesses. Apptis, Inc., was considered a small business under NAICS code 517110, but this company was awarded the contract under full and open competition.

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## NAICS Code Selection

Contracting officials did not comply with the FAR procedures by assigning the ITES-2S contract a NAICS code based on the most liberal determination of small business size standards, rather than a code that best describes the principal nature of the services to be acquired. Contracting officials stated that NAICS code 517110 was used because its small business size standard was considered to be more liberal. In fact, the associated size standard used by contracting officials for the ITES-2S is the largest of all small business size standards established by the SBA.

A memorandum prepared by ITES-2S contracting officials, “NAICS Code Determination for ITES-2S,” March 8, 2005, describes how contracting officials considered two NAICS codes in determining which would be assigned to the ITES-2S contract. The codes considered were 517110, “Wired Telecommunications Carriers,” and 541519, “Other Computer Related Services.” As documented in the memorandum, contracting officials determined that there was no single code that appropriately covers the complexity and the worldwide magnitude of the ITES-2S acquisition. Contracting officials stated that NAICS code 517110 allowed the most liberal small business threshold, and therefore selected this code in order to facilitate proposal opportunities for firms with greater technological compatibilities. However, according to the FAR, the size standard is assigned by classifying the service being acquired in the industry whose definition, as found in the NAICS manual, best describes the principal nature of the service being acquired; not by assigning the code that is associated with the preferred size standard. IT services will be acquired under ITES-2S. However, NAICS code 517110 does not describe an industry that provides IT services. Codes within NAICS section 54151, “Computer Systems Design and Related Services,” best describe an industry that provides IT services, and therefore, a code within section 54151 should have been assigned to ITES-2S. By assigning NAICS code 517110 to the ITES-2S solicitation, contracting officials disregarded the FAR requirement to select the code that best describes the services to be provided.

Although the Army expects the ITES-2S to replace the smaller ITES-EMS3 contract, prior to assigning the ITES-2S NAICS code, contracting officials did not review the task orders issued under the ITES-EMS3 contract to determine which tasks accounted for the greatest percentage of the contract price. The FAR states that when acquiring a service that could be classified in two or more industries with different size standards, contracting officials must apply the size standard for the industry accounting for the greatest percentage of the contract price. When asked, contracting officials stated that they did not review the prior contract, nor did they perform analysis beyond the memorandum to determine what NAICS code accounted for the greatest percentage of the ITES-2S contract price. Furthermore, based on our review of the ITES-2S Independent Government Cost Estimate, we determined that IT services classified under NAICS codes within section 54151, “Computer Systems Design and Related Services,” would account for the greatest percentage of the contract price.

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Additionally, in supporting their decision to use NAICS code 517110, contracting officials referenced an SBA notice entitled “Standard Industrial Classification (SIC) 4813 Clarification,” July 5, 1989. SIC code 4813 is the predecessor to NAICS code 517110; the NAICS replaced SIC in 1997. According to the United States Census Bureau, the NAICS codes were revised in 2002. The SBA notice states that SIC 4813 is appropriate when the telecommunications services solicited require in-depth knowledge of the technologies developed by firms typically classified in SIC 4813 and when a combination of telecommunications services is included in a statement of work evidencing that the intent of the procurement is to acquire a telecommunications system. However, the ITES-2S acquisition plan states that systems will not be acquired through the ITES-2S contract vehicle. Further, SIC 4813 pertains directly to telephone and data communications. However, based on the task areas identified in the ITES-2S solicitation, IT services, not telephone and data communications, represent the primary purpose of the acquisition. In addition, the notice used by contracting officials in support of using NAICS code 517110 expired in February 1990, 15 years prior to the ITES-2S solicitation.

The NAICS code assigned to the ITES-2S by contracting officials was not selected based on the criteria established in the FAR. Instead, contracting officials assigned an inappropriate code that allowed businesses that would have been considered large if the appropriate code was chosen, to compete for small business reserve awards. As a result, no appropriately qualified small businesses were awarded ITES-2S prime contracts.

## **Implications of Consolidation and NAICS on Small Business**

Contract consolidation and the selection of an inappropriate NAICS code both precluded appropriately qualified small businesses from participating in ITES-2S. As a result, ITEC4 contracting officials also bundled the ITES-2S contract, which resulted in a contract that was unsuitable for small business prime contracting awards.

**Consolidation.** As previously mentioned, the most appropriate small business size standard for ITES-2S was for a small business with \$23 million in average annual receipts. However, small businesses under the \$23 million size standard threshold were not adequately considered for award for ITES-2S. A memorandum prepared by ITES-2S contracting officials, “DD2579, Small Business Coordination Record, ITES-2S,” March 19, 2005, identified that small businesses with annual receipts of \$21 million or below could not provide the depth/breadth of task areas required to cover a full spectrum of enterprise requirements. Therefore, contracting officials determined that ITES-2S requirements were too broad for these small businesses to perform. Even though these small businesses could provide for a portion of the requirements, when all requirements for IT services became consolidated into one requirement under ITES-2S, these small businesses could not compete for contract award.

Consolidation can preclude small business prime contracting participation by combining requirements from previous separate contracts into one requirement

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under a single contract. When the requirements are separated under multiple contracts, small businesses have an appropriate opportunity to compete for award. However, when the requirements are consolidated into one requirement under one contract, the consolidated requirement can be too broad for small businesses to perform, and therefore, many small businesses cannot successfully compete for the consolidated requirement even though they could successfully perform portions of that requirement.

By consolidating requirements under ITES-2S, the scope of work became too broad for appropriately qualified small businesses to successfully compete for prime contract awards. Additionally, no portion of the work was set aside for small businesses. As a result, small businesses under the \$23 million size standard were not afforded an appropriate opportunity to compete for prime contract awards as mandated in 10 U.S.C. 2382.

**NAICS Code Selection.** As a result of the contracting office's selection of an incorrect NAICS code, appropriately qualified small businesses were not provided a fair opportunity to compete for ITES-2S prime contracts. Further, businesses that should have been considered large were inappropriately awarded small business award reserves, while appropriately qualified businesses were left to unsuccessfully compete against businesses up to 30 times their size in terms of annual revenue.

Additionally, as a result of inappropriately awarding small business award reserves to businesses that should be considered large, future task orders awarded to these businesses will incorrectly be reported toward small business achievements.

**Contract Bundling.** By consolidating requirements, the scope of work became too broad for appropriately qualified small businesses to successfully compete for prime contract awards. Furthermore, by selecting an incorrect NAICS code, appropriately qualified small businesses were not provided a fair opportunity to compete for small business award reserves. The combination of these factors makes ITES-2S a bundled contract.

## **Bundling Policy**

**Federal Acquisition Regulation.** FAR Subpart 2.1, "Definitions," and Subpart 7.1, "Acquisition Plans," address contract bundling. The FAR defines "bundling" as the consolidation of "two or more requirements for supplies or services, previously provided or performed under separate smaller contracts, into a solicitation for a single contract that is likely to be unsuitable for award to a small business concern." The FAR states that "bundling may provide substantial benefits to the Government; however, due to the potential impact on small business participation, the head of the agency must conduct market research to determine whether bundling is necessary and justified." "Market research may indicate that bundling is necessary and justified if an agency or the Government would derive measurably substantial benefits." The benefits should be quantified in the market research.

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**United States Code.** According to 15 U.S.C. 631, “each Federal agency, to the maximum extent practicable, shall avoid unnecessary and unjustified bundling of contract requirements that preclude small business participation in procurements as prime contractors.” In reference to contract bundling, 15 U.S.C. 644 states that “before proceeding with an acquisition that could lead to a contract containing consolidated procurement requirements, the head of an agency should conduct market research to determine whether consolidation of the requirements is necessary and justified.”

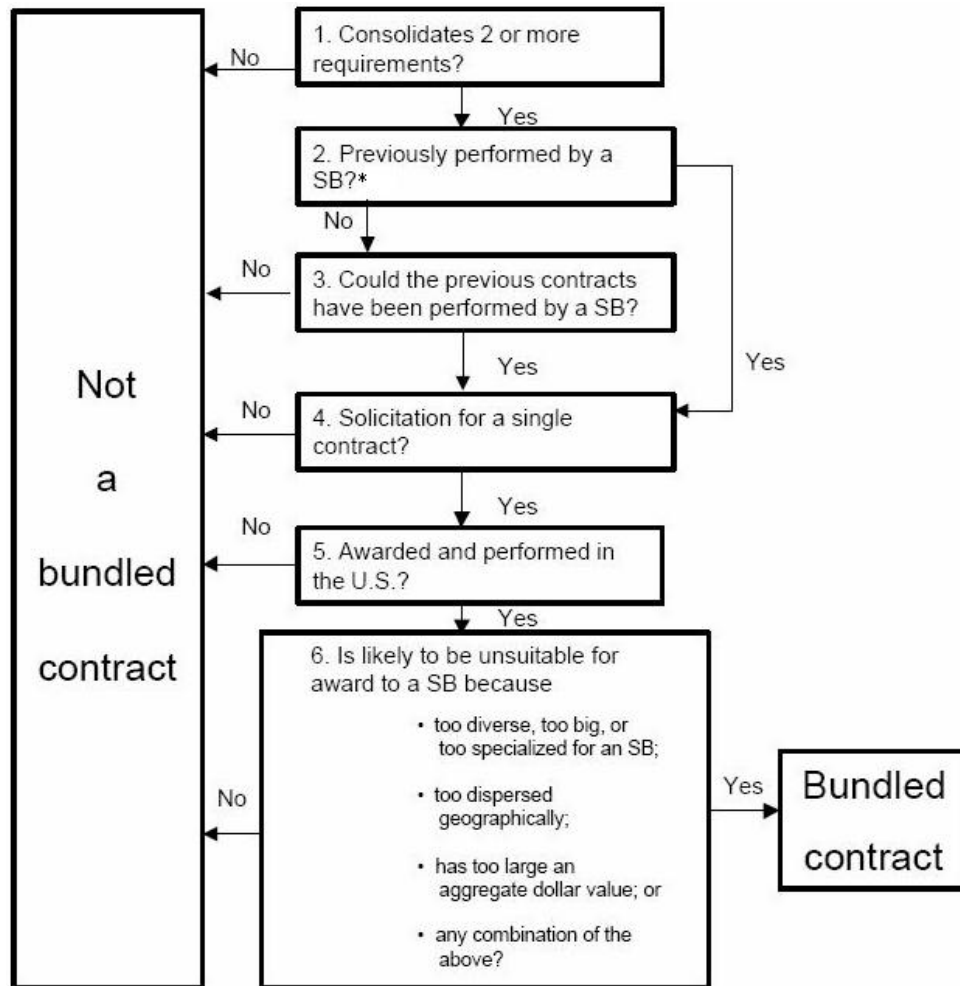
**Memorandum for Service Acquisition Executives Directors, Defense Agencies.** According to the memorandum signed by the Under Secretary of Defense for Acquisition, Technology, and Logistics, “Small Business Participation in Consolidated Contracts,” January 17, 2002, each proposed contract award must be evaluated against the FAR criteria for bundled requirements. In addition, the memorandum states that, in order to proceed with a bundled contract, there must be measurably substantial benefits as defined in the FAR. In this case, FAR 7.107(e), “Additional Requirements for Acquisitions Involving Bundling,” states substantial bundling is any bundling that results in a contract or order that meets or exceeds \$7 million, as required by DoD. The memorandum goes on to state, if substantial bundling occurs, the agency must quantify the benefits and explain how they would be measurably substantial.

## **Bundling Determination**

The ITES-2S acquisition plan states that the ITES-2S acquisition was analyzed using the six criteria identified in the “Department of Defense, Office of Small and Disadvantaged Business Utilization, Benefit Analysis Guidebook” in determining whether the ITES-2S contract was bundled. The six criteria are derived from the definition of bundling in the FAR and public law. The guidebook contains the flowchart that follows, which outlines the six bundling criteria.

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## Decision Flowchart for Determining Whether a Contract Is Bundled



\*SB = Small Business.

In a memorandum, "Bundling Determination for Information Technology Enterprise Solutions-2 Services (ITES-2S)," June 20, 2005, contracting officials stated that when applying the six criteria identified above, three of the criteria were not met; therefore, the contract was not considered to be bundled. However, using the same flowchart process, we determined that the contract is indeed bundled. Below is a discussion of each of the six criterion as they relate to the ITES-2S contract.

### 1. Are two or more requirements consolidated?

**ITEC4 Analysis:** Contracting officials stated that ITES-2S is not consolidating two or more requirements and that the ITES-2S contract is a follow-on to the ITES-EMS3.



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**Audit Analysis:** As explained previously in this report, ITES-2S does consolidate two or more requirements. Therefore, ITES-2S meets this criterion.

**2. Did a small business previously perform any of the requirements?**

**ITEC4 Analysis:** Contracting officials stated that ITES-EMS3 is being performed by two small businesses.

**Audit Analysis:** Two small businesses were awarded ITES-EMS3 contracts. Even though this criterion is met because small businesses were awarded ITES-EMS3 contracts, we further note that many of the Army solicitations for IT services identified at FedBizOpps were completely set aside for participation by small businesses that qualify under the \$23 million size standard.

**3. Could a small business have performed any of the requirements?**

**ITEC4 Analysis:** Contracting officials stated that this criterion is not applicable, because it was previously performed by small businesses.

**Audit Analysis:** As shown in the flowchart, if criterion number 2 is met, criterion number 3 is not applicable. However, even if criterion number 2 were not met, small businesses could have performed some of the requirements, thereby meeting criterion number 3. Aside from the ITES-EMS3, other contracts that address requirements identified in the ITES-2S contract have been performed by small businesses. The following are examples of IT contracts that allow small business participation and contain requirements similar to some of those found in the ITES-2S contract:

- Encore Information Technology Solutions Contract, Defense Information Systems Agency;
- Minority Institutions Technology Support Services II Contract, Defense Information Systems Agency; and
- Streamlined Technology Acquisition Resources for Services Contract, General Services Administration.

**4. Will the solicitation result in a single contract?**

**ITEC4 Analysis:** Contracting officials stated that the ITES-2S contract will result in the award of multiple IDIQ contracts.

**Audit Analysis:** In the context of bundling, the FAR states that a “single contract” includes multiple awards of IDIQ contracts under a single solicitation for the same or similar supplies or services to two or more sources. Therefore, the ITES-2S contract meets this criterion.

**5. Will contract performance occur in the United States?**

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**ITEC4 Analysis:** Contracting officials stated that ITES-2S performance will occur both in the U.S. and abroad. Therefore, the ITES-2S meets this criterion.

**Audit Analysis:** The ITES-2S contract includes worldwide requirements.

**6. Is the proposed contract likely to be unsuitable for award to a small business?**

**ITEC4 Analysis:** Contracting officials stated that “awards under the ITES-2S are not ‘unsuitable for award to a small business.’ ”

**Audit Analysis:** By assigning an incorrect NAICS code to the ITES-2S, contracting officials improperly awarded small business reserves to businesses not categorized as small per the appropriate NAICS code. Therefore, no appropriately qualified small businesses were awarded ITES-2S contracts. In addition, the broad scope, large ceiling price, and geographical dispersion of the ITES-2S contract further restricts small business participation. As a result, the contract meets this criterion of being unsuitable for small business award.

The ITES-2S contract is bundled because it meets all of the applicable bundling criteria; therefore, as required by 15 U.S.C. 644 and FAR Subpart 7.1, bundling justification is required. However, because contracting officials determined that ITES-2S was not a bundled contract, no steps were taken to justify the bundling. The negative impacts of contract bundling have been cited by both the Office of Federal Procurement Policy and the SBA. Bundling decreases contracting opportunities for small businesses and can hurt the Government through a reduced supplier base. A report<sup>3</sup> by the Office of Federal Procurement Policy notes that substantially fewer small businesses are receiving Federal contracts as result of an increase in contract bundling. According to a report<sup>4</sup> prepared for SBA, the larger number of tasks required for fulfilling bundled contracts and the consequent increase in dollar size of these contracts favor large businesses and larger small businesses while inhibiting the ability of small or new firms to bid on and win Federal contracts. Additionally, this report notes that as bundled contracts increase in number and size, small businesses’ contract and dollar shares decline. This report estimated that for every additional \$100 awarded on a bundled contract there was a decrease of \$12 awarded to small businesses. Although it was not within the scope of this audit to determine the aggregate effects of contract bundling, the negative effects have been noted by other Government agencies, and Federal regulations are written in a manner as to ensure contracts are not bundled unless the Government will obtain measurably substantial benefits from doing so.

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<sup>3</sup>Office of Federal Procurement Policy, “Contract Bundling, A Strategy for Increasing Federal Contracting Opportunities for Small Business,” October 2002.

<sup>4</sup>Office of Advocacy, U.S. Small Business Administration, “The Impact of Contract Bundling on Small Business FY 1992 – FY 2001,” October 2002.

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## Alternative Approaches

If ITEC4 contracting officials had determined the appropriate NAICS code, they would have realized that the contract was bundled, and could have taken proactive steps to alleviate the situation. Officials could have taken the following proactive steps:

- severed the requirements into smaller acquisitions,
- set aside an appropriate portion of the contract for small businesses, or
- properly justified the need to keep the contract bundled.

The General Services Administration is soliciting a similar IT services contract with a ceiling price that could potentially reach \$65 billion. However, unlike the ITES-2S contract, the General Services Administration has separated the requirement into two contracts, one for small business and one for large business. Additionally, the General Services Administration assigned NAICS code 541512, “Computer Systems Design Services,” for both large and small business contracts.

## Summary

Army contracting officials did not give proper consideration to small business participation in the ITES-2S contract award. In selecting a NAICS code for the ITES-2S solicitation, contracting officials disregarded FAR requirements to make the selection based on the code definition that best described the services to be acquired and instead selected a code that allowed for the most liberal determination of small business size standards. As a result, businesses that should have been considered large were inappropriately awarded prime contracts reserved for small businesses. Further, contracting officials did not comply with DFARS procedures for consolidating contract requirements without justification. The consolidation of contract requirements and lack of participation by appropriately qualified small businesses resulted in the ITES-2S contract being considered bundled. Bundling a contract without justification violates 15 U.S.C. 644 and FAR Subpart 7.1.

## Management Comments on the Finding and Audit Response

In a memorandum, “Information Technology Enterprise Solutions-2 Services Contract,” December 8, 2006, we requested that the Assistant Secretary of the Army for Acquisition, Logistics, and Technology delay the award of the ITES-2S contract until after the problems identified in this report were resolved. We did not receive the Assistant Secretary’s response, dated January 17, 2007, until May 23, 2007, after we repeatedly requested comments to the draft report.

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In the January 17, 2007, memorandum, the Assistant Secretary stated that it was not possible for the U.S. Army to comply with our request to delay the award, as all of the ITES-2S contracts were awarded prior to receipt of the December 8, 2006, memorandum. He added that 11 awards were made on April 14, 2006, and an additional 5 awards were made on December 4, 2006. The Assistant Secretary stated that the U.S. Army disagrees with our analysis of the NAICS code issue.

We are responding to these comments through our response to the Assistant Secretary's comments to the recommendations, because we did not receive these comments until after issuance of the draft report. According to the Assistant Secretary in the January 17, 2007, memorandum, there was not a single code that covered the complexity and magnitude of the ITES-2S acquisition; therefore, the U.S. Army's contracting officer made the most appropriate choice among the possible codes. He added that according to 13 C.F.R. Section 121.402(b) (2006), the type of work performed is not the only consideration in choosing the NAICS code. Other factors to consider include previous Government procurement classifications of the same or similar products or services, and the classification that would best serve the purposes of the Small Business Act. The Assistant Secretary stated that any small business was allowed to compete, and the Army did not receive any proposals from small businesses that would have qualified under a more restrictive size standard. Therefore, he stated there was no competitive disadvantage or bundling. According to the Assistant Secretary, any challenge to the contracting officer's choice of NAICS code must be raised within 10 days of the issuance of the solicitation. Therefore, he stated the NAICS code for ITES-2S became final as of September 2005 and is not subject to further review.

## Recommendations

**Revised Recommendation.** The Assistant Secretary of the Army for Acquisition, Logistics, and Technology provided management comments on behalf of the Director, Army Contracting Agency and the Director, Army Small and Disadvantaged Business Utilization. We revised Recommendation 1.c. because it is no longer reasonable for the U.S. Army to re-compete the base ITES-2S contract because task orders have been awarded and services rendered. However, we maintain that the NAICS code used is incorrect and the contract is bundled.

**1. We recommend that the Director, Army Contracting Agency take the following actions:**

**a. Revise the North American Industry Classification System code assigned to the Information Technology Enterprise Solutions-2 Services contract to an appropriate code defined in the North American Industry Classification System manual under section 54151, "Computer Systems Design and Related Services."**

**Management Comments.** The Assistant Secretary of the Army for Acquisition, Logistics, and Technology, responding for the Director, Army Contracting

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Agency, nonconcurred with the recommendation. The Assistant Secretary nonconcurred based on the broad scope of the ITES-2S requirements, the nature of the work performed, the pre-approval of the NAICS code, and small business participation.

**Broad Scope.** The Assistant Secretary stated that selecting a NAICS code based on the procedures outlined in FAR 19.102 poses a challenge for IDIQ contract vehicles like ITES-2S because of its extremely broad scope and the fact that there are no definitized requirements until task orders are issued. He further noted that the U.S. Army could only make its best estimate to what work will be performed under ITES-2S.

**Nature of Work.** The Assistant Secretary stated that the draft report indicated that contracting officials selected the NAICS code based solely for the purpose of obtaining a preferred size standard and did not consider the nature of work. He contended that this was incorrect, and that the contracting officer considered the nature of work in making her decision. The Assistant Secretary referenced the March 8, 2005, memorandum prepared by the contracting officer that stated that the objective of the acquisition was to provide for a full range of services and solutions necessary for the Army to satisfy its support of the Army enterprise infrastructure and infostructure goals with IT services worldwide. The Assistant Secretary stated that the memorandum also compared the ITES-2S work with NAICS codes 541519 and 517110 and concluded that no single code covered the complexity of the ITES-2S acquisition and that NAICS code 517110 best described the makeup of this acquisition. He stated that although the memorandum stated that NAICS code 517110 allowed for the most liberal small business standard, the comment does not demonstrate that the contracting officer failed to consider the nature of the work in selecting the NAICS code.

The Assistant Secretary stated the report made certain assertions based upon a selective consideration of acquisition documentation that revealed that the Inspector General has misconstrued the nature of the requirement. He further stated that, according to the report, the ITES-2S acquisition is predominantly for services; that hardware and software are incidental; the vast majority of costs in the Independent Government Cost Estimate are related to IT services; and that systems will not be acquired through the ITES-2S contract vehicle. The Assistant Secretary contended that although the services are unquestionably an essential component, ITES-2S is not just for the procurement of services, and that equipment is not an insignificant part of the acquisition. He further contended that as an IDIQ vehicle involving requirements that will be definitized only at the task order level, the ITES-2S contracts do not represent system procurements, but the provision of total solutions under ITES-2S at the task order level is a fundamental objective of the procurement.

The Assistant Secretary stated that there are multiple references in the acquisition plan that emphasize the need for end-to-end solutions that include equipment as well as services. He added that awardees are responsible for providing IT services and a full range of IT hardware and software; however, the procurement of IT equipment must be related to the acquisition of the services, and is therefore considered incidental. He stated that although the IT equipment is incidental, that does not nullify the essential importance of the equipment to the

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provision of end-to-end solutions. The Assistant Secretary stated that the non-labor, solution-based costs in the Independent Government Cost Estimate, which includes costs for equipment and other items, represented 39 percent of total costs.

**SBA Notice.** The Assistant Secretary stated that the draft report mentioned that the contracting officer relied upon an SBA notice, “Standard Industrial Classification (SIC) 4813 Clarification,” although it had expired. According to the Assistant Secretary, even though the SBA notice had expired, SIC code 4813 was the predecessor to NAICS code 517110, and the notice provided insight into the view of the SBA on the scope of the code. He added that the notice makes clear that the code is appropriate for services that comprise disciplines in various SIC codes and that it encompasses providing equipment as well as services.

**Other Considerations – Draft Comments.** The Assistant Secretary stated that the selected NAICS code is broader than the Inspector General suggests and does not only apply to telephone companies such as AT&T. According to the Assistant Secretary, the contracting officer selected the NAICS code based upon various legitimate considerations, and her determination was confirmed, prior to the issuance of the solicitation, by the DoD Small and Disadvantaged Business Utilization officials of both the Army and DoD, and by the SBA itself.

The Assistant Secretary stated that although the type of work to be performed under the contract is important in selecting a NAICS code, it is not the only consideration. He quoted 13 C.F.R. Section 121.402(b) (2006), which states that other factors considered include previous Government procurement classifications of the same or similar products or services, and the classification that would best serve the purposes of the Small Business Act. He further stated that other DoD procurements, to include the Air Force’s Network-Centric Solutions contracts and the ITES-2S predecessor vehicle, ITES-EMS3, used the same NAICS code as was used for the ITES-2S contract. The Assistant Secretary believes that the other factors identified in 13 C.F.R. 121.402(b) (2006) justified the use of NAICS code 517110 and that by ignoring these other considerations the DoD Inspector General’s analysis runs counter to the regulation. In his January 17, 2007, memorandum, the Assistant Secretary stated that the NAICS code chosen for the ITES-2S contract best met the purposes of the Small Business Act.

**Protesting and Approval.** The Assistant Secretary stated that prior to the issuance of the ITES-2S solicitation, the NAICS code 517110 was approved by the U.S. Army and DoD Small and Disadvantaged Business Utilization offices and the SBA. In addition, the NAICS code was briefed to the Senate and House Small Business Committee staffs; no one gave a negative response.

The Assistant Secretary further stated that the NAICS code selection is no longer a protestable issue, and the NAICS code selected was never challenged under ITES-2S. The Assistant Secretary added that according to 13 C.F.R. 121.402(c) (2006), the NAICS code assigned to a procurement and its corresponding size standard is final unless timely appealed to SBA’s Office of

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Hearing and Appeals, or unless SBA assigns an NAICS code or size standard as a result of a complaint to SBA. However, the Assistant Secretary stated that in the case of ITES-2S, no challenge was ever filed against the choice of NAICS code, nor did any companies otherwise voice dissatisfaction with the Army's choice of code.

**Small Business Preclusion – Draft Comments.** The Assistant Secretary stated that the selected code did not preclude smaller businesses from submitting proposals, but merely established an upper limit for how large a company could be in order to be considered small. He added that the ITES-2S strategy included significant and impressive minimum mandatory small business subcontracting goals, requiring offerors to guarantee overall small business participation of 25 percent of dollars awarded. He stated that the solicitation also required the offerors to identify their small business teaming partners and the extent of commitment to use the firms. He added that the 25 percent for small business participation equates to a potential \$5 billion geared towards small businesses based upon the contract maximum of \$20 billion. In response to the draft report, the Assistant Secretary stated that the chosen NAICS code did not preclude any smaller-sized companies from submitting proposals, but merely permitted larger-sized companies to qualify as small businesses. He contended that the code selected fosters small business participation by reserving prime contracts for small businesses.

**Small Business Preclusion – Memorandum Comments.** Additionally, in his January 17, 2007, memorandum, the Assistant Secretary stated that the selected code's appropriateness was confirmed by ample research and based on that research, the ITES-2S contracting officer concluded that a NAICS code with a smaller size standard would have slanted the ITES-2S awards toward companies that were unable to provide the depth/breadth of task orders required to meet enterprise requirements and manage large numbers of task orders. In the memorandum, the Assistant Secretary stated that although the SBA size standard corresponding to NAICS code 517110 is larger than the standards associated with many other NAICS codes, the contracting officer's choice of NAICS code 517110 was appropriate and ultimately did not exclude smaller small businesses from participating in the acquisition. Additionally, he stated that in the course of choosing NAICS code 517110, the contracting officer concluded, in effect, that smaller small businesses did not meet the purpose of the ITES-2S procurement. Furthermore, the Assistant Secretary stated that the use of NAICS code 517110 permitted participation by small businesses meeting the larger size standard, and that no proposals were received from any small businesses that would have qualified under a more restrictive size standard. The Assistant Secretary concluded that there was no basis to conclude that smaller businesses were placed at any competitive disadvantage.

**Audit Response.** We disagree with the Assistant Secretary's comment that the NAICS code chosen by the contracting officer was the most appropriate code for ITES-2S. Although the Assistant Secretary provided explanations for the use of NAICS code 517110 based on the broad scope of the ITES-2S requirements, the nature of the work performed, the pre-approval of the NAICS code, and small business participation, his arguments ultimately did not explain how the IT



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services or even the IT equipment to be acquired under ITES-2S related to NAICS code 517110.

**Broad Scope.** We are concerned about the Assistant Secretary's comments that there are no definitized requirements until task orders are issued and that the U.S. Army could only make its best estimate to what work will be performed under ITES-2S. FAR Part 10, "Market Research," states that agencies must:

- "ensure that legitimate needs are identified;
- conduct market research before developing new requirements documents for an acquisition by that agency and before soliciting offers for acquisitions with estimated value over the simplified acquisition threshold; and
- use the results of market research to determine if sources exist that are capable of satisfying the agency's requirements."

FAR Part 11, "Describing Agency Needs," states that agencies shall specify needs using market research in a manner designed to promote full and open competition. Additionally, FAR Section 16.504, "Indefinite-Quantity Contracts," states the following:

A solicitation and contract for an indefinite quantity contract must . . . include a statement of work, specifications, or other description, that reasonably describes the general scope, nature, complexity, and purpose of the supplies or services the Government will acquire under the contract in a manner that will enable a prospective offeror to decide whether to submit an offer.

FAR Section 16.504 also states the following:

Contracting officers may use an indefinite-quantity contract when the Government cannot predetermine, above a specified minimum, the precise quantities of supplies or services that the Government will require during the contract period, and it is inadvisable for the Government to commit itself for more than a minimum quantity. The contracting officer should use an indefinite-quantity contract only when a recurring need is anticipated.

Therefore, the use of an IDIQ contract requires the contracting officer to identify a recurring need. If the contracting officer could not reasonably describe the types of services or supplies she was intending to acquire under ITES-2S, then this type of contract should not have been utilized. General requirements should have been identified at the IDIQ contract level, with specifics on when and where (indefinite-delivery) and how much (indefinite-quantity) should be identified at the task order level.

The Assistant Secretary's comments led the audit team to believe that proper market research was not conducted to determine whether an actual need existed nor could the U.S. Army reasonably describe the general scope of the services to be acquired. Without reasonably definitive requirements, potential bidders could not fully understand what the Government was soliciting, and as a

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result, full and open competition may not have existed. In addition, without definitive requirements the U.S. Army should have taken proactive steps to avoid noncompliance with the FAR, such as using a different type of contract vehicle or severing the requirements into smaller acquisitions.

**Nature of Work.** The contracting officials may have considered the nature of work when selecting the NAICS code, but ultimately the decisions made were incorrect when selecting the NAICS code. Additionally, it was evident that the contracting officer did factor in the preferred size standard when selecting the NAICS code. As mentioned previously in this report, the contracting officer specifically stated that NAICS code 517110 was used because its small business size standard was considered to be more liberal. Additionally, as noted in this report and in the Assistant Secretary's comments, the aforementioned March 8, 2005, memorandum states that NAICS code 517110 allowed the most liberal small business size threshold, and therefore, would facilitate proposal opportunities for businesses with greater technological compatibilities. In accordance with the FAR, the NAICS code should have been selected based on the principle purpose of the products and services to be acquired and not based on a preferred size standard that would allow larger small businesses to compete for task orders over smaller sized businesses.

In response to the Assistant Secretary's allegation that the Office of Inspector General misconstrued the nature of the requirement based on a selective consideration of acquisition documentation, we disagree. Our analysis was based on a review of three major acquisition documents: the acquisition plan, contract solicitation, and the contract. The ITES-2S acquisition plan specifically states that ITES-2S is predominantly services with incidental hardware and software, and although hardware and software will be acquired through Army Small Computer Program contract vehicles, systems will not be acquired. In addition, the ITES-2S acquisition plan and solicitation specifically describe the scope of the work for ITES-2S as service-based. Further, the ITES-2S solicitation states that the ITES-2S scope will include a full range of services and solutions necessary for the Army to satisfy its support of the Army enterprise infrastructure and infostructure goals with IT services worldwide. We note that the name of the contract even includes the terms "IT" and "services." Additionally, the U.S. Army has awarded a separate IDIQ contract, the Information Technology Enterprise Solutions-2 Hardware (ITES-2H) contract, for the primary purpose of acquiring IT hardware. Therefore, even though incidental IT hardware will be acquired through ITES-2S, the principle purpose of the acquisition is still for IT services, whereas the principal purpose of the separate ITES-2H contract is for IT hardware.

According to the Assistant Secretary, 39 percent of the Independent Government Cost Estimate is for non-labor, solution-based costs, to include equipment and other items. This means the remaining 61 percent is for labor, service-related costs. According to our analysis of the Independent Government Cost Estimate, we concluded that 68 percent of the costs were directly related to IT services. Nonetheless, we maintain our position that a NAICS code in section 54151 should have been used for the acquisition, based on FAR Part 19.102. As mentioned in the report, FAR Part 19.102 states that when acquiring a service that could be classified in two or more industries with different size standards,

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contracting officials must apply the size standard for the industry accounting for the greatest percentage of contract price. The labor and service-related costs of the Independent Government Cost Estimate, whether 61 percent or 68 percent, represent the greatest percentage of the price.

The Assistant Secretary's arguments do not explain how the IT services or equipment acquired under ITES-2S relate to NAICS code 517110. The information within the ITES-2S solicitation does not remotely describe work to be performed by an industry that would be classified under NAICS code 517110, "Wired Telecommunications Carriers." The industry classified under NAICS code 517110 performs the work associated with a telephone company. Therefore, we maintain that a code within NAICS section 54151, "Computer Systems Design and Related Services," would best describe the services to be acquired under ITES-2S. Any argument by the Assistant Secretary and the contracting officer that ITES-2S is not for the acquisition of IT service solutions contradicts what is written in the solicitation and acquisition plan, which is the basis for contracting decisions.

**SBA Notice.** In response to the Assistant Secretary's statement regarding the contracting officer's use of the expired SBA notice, "Standard Industrial Classification (SIC) 4813 Clarification," to provide insight into the view of the SBA on the scope of the code, we maintain our current position. Not only did the SBA notice expire 15 years prior to the ITES-2S solicitation, SIC 4813 pertains directly to telephone and data communications. As stated in the report, the SBA notice states that SIC 4813 is appropriate when the telecommunications services solicited require in-depth knowledge of the technologies developed by firms typically classified in SIC 4813 and when a combination of telecommunications services is included in a statement of work evidencing that the intent of the procurement is to acquire a telecommunications system. In addition, as previously stated in the report, the ITES-2S acquisition plan clearly states that systems will not be acquired; therefore, the primary purpose of the ITES-2S acquisition remains IT services. For that reason, we do not understand how the insight provided by the SBA notice on the scope of the code could include acquisition of IT services, when the SBA notice specifically states that it applies to telecommunications services.

We also note that the 1987 SIC codes were replaced by NAICS to enhance comparability across three countries. The goal of NAICS is to reflect the current economy in the United States, Canada, and Mexico. NAICS identifies service industries not identified in the SIC. Compared to the SIC, NAICS includes an additional 358 new industries, of which 250 are service-related industries. Therefore, NAICS is more comprehensive than the SIC and focuses on a services-based economy.

**Other Considerations.** In response to the Assistant Secretary's statement that NAICS code 517110 is broader than the Inspector General suggests, we disagree. As previously stated in the report, NAICS code, "Wired Telecommunications Carriers," is defined in the NAICS manual as an industry engaged in operating and maintaining switching and transmission facilities to provide point-to-point communications via landlines, microwave, or a combination of landlines and satellite linkups or furnishing a telegraph and other

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non-vocal communications using their own facilities. The report also identifies index entries included with the NAICS definition. This description directly corresponds to activities performed by a telephone company. The principal purpose of the ITES-2S contract, acquisition of IT services, was not included in the NAICS manual definition of code 517110.

In reference to the Assistant Secretary's interpretation of 13 C.F.R. Part 121 (2006), we disagree that other factors justify the use of NAICS code 517110. The Assistant Secretary did not consider 13 C.F.R. Section 121.402(b) (2006) in its entirety. This C.F.R. specifically states:

Primary consideration is given to the industry descriptions in the NAICS United States Manual, the product or service description in the solicitation and any attachments to it, the relative value and importance of the components of the procurement making up the end item being procured, and the function of the goods or services being purchased.

Previous Government procurement classifications of the same or similar products or services are secondary factors. According to the FAR and C.F.R., the primary factors for selecting a NAICS code are the principal purpose of the products or services being acquired and the products or services accounting for the greatest percentage of the contract price. As previously discussed, the principle purpose of ITES-2S was for the acquisition of IT services, and therefore, a NAICS code relevant to the IT industry should have been selected.

Although other procurements were assigned NAICS code 517110, the audit team can neither confirm nor deny that these procurements were assigned the correct NAICS code or that the ITES-2S scope of work was similar to that of these other procurements. Furthermore, a similar review of the Network-Centric Solutions procurement was performed by the Office of Inspector General with similar results to that of our review of ITES-2S. Specifically, it was determined that the NAICS code chosen for the Network-Centric Solutions contract vehicle did not appropriately represent the principle purpose of the products and services to be acquired and did not represent the products and services accounting for the greatest percentage of the contract price. Additionally, it was determined that a code within NAICS section 54151 would have been more appropriate for the Network-Centric Solutions acquisition.

In response to the Assistant Secretary's statement that the NAICS code chosen for the ITES-2S contract best met the purposes of the Small Business Act, we disagree. As previously mentioned in the report, the code chosen by the Army officials, NAICS code 517110, "Wired Telecommunications Carriers," was chosen based on the most liberal determination of small business size standards, rather than what best meets the definition of the services to be acquired under the ITES-2S contract. As a result, businesses were inappropriately awarded prime contracts reserved for small business awards.

**Protesting and Approval.** In response to the Assistant Secretary's statements about the approvals of small business representatives, we do not believe these approvals prove that a correct NAICS code was selected. We met with the Procurement Center Representative for the SBA who signed the ITES-2S Small Business Coordination Record, and he stated that his signature did not

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indicate approval of NAICS code 517110. Additionally, he stated that unless a complaint is made by a potential contractor, further consideration is typically not made regarding the NAICS code selected. Recommendation 2. was prepared to enable the Army Office of Small and Disadvantaged Business Utilization to ensure similar errors will be discovered in future procurements.

We also met with the ITEC4 Small Business Advisor, who stated that if a NAICS code allowing for smaller small businesses had been chosen, those businesses would have expressed an interest, but would not have been able to successfully compete for the contract. Therefore, the ITEC4 Small Business Advisor's comments indicate that the primary concern when selecting the NAICS code was choosing a code with the most liberal determination of small business size standards. In addition, we did not receive documentation to verify that the Senate and House Small Business Committee staffs approved the NAICS code. Ultimately, however, in accordance with the FAR and C.F.R., the contracting officer is responsible for selecting the NAICS code.

In reference to the Assistant Secretary's statements about protesting the NAICS code, we understand that the deadline for protesting the NAICS code selected by the contracting officer has expired. We also understand that the NAICS code selected for ITES-2S was not formally protested. However, the lack of protest does not validate that the code selected was the most appropriate code. The DoD Office of Inspector General is not protesting the NAICS code selection, but simply stating that the U.S. Army made an error in the selection of NAICS code 517110.

**Small Business Preclusion.** In response to the Assistant Secretary's response that the use of NAICS code 517110 did not exclude participation by smaller small businesses, we disagree. As described within this report, NAICS code 517110 has the largest size standard allowed by SBA. No income limitation is placed on NAICS code 517110. Therefore, businesses receiving up to approximately \$700 million in yearly revenue, as is the case for Apptis Inc., can qualify as a small business under NAICS code 517110. However, businesses that qualify as small under a NAICS code within NAICS section 54151 must not exceed \$23 million in yearly revenue. Compared with businesses like Apptis Inc., small businesses under the \$23 million threshold are at a severe competitive disadvantage because these smaller small businesses cannot provide the volume of work a larger small business can provide. By selecting NAICS code 517110, these smaller small businesses were forced to compete with businesses that should have been considered large businesses under an appropriate NAICS code.

As noted previously, the Assistant Secretary stated that based on research conducted, the ITES-2S contracting officer concluded that a NAICS code with a smaller size standard would have slanted the ITES-2S awards toward companies that were unable to provide the depth/breadth of task areas required to meet enterprise requirements. The Assistant Secretary also stated that the contracting officer concluded that smaller small businesses did not meet the purpose of the ITES-2S procurement. Therefore, it was determined by the contracting officer that small businesses under the \$23 million threshold were too small to perform the volume of work under ITES-2S. As result, these smaller small businesses had little to no chance of ever receiving a prime contract under ITES-2S, and it would

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have been futile for these businesses to go through the effort and expense of creating a proposal and placing a bid for a contract that the contracting office had already determined would not be awarded to businesses of their size. Additionally, the research and determinations described above by the Assistant Secretary are ultimately irrelevant in determining the appropriate NAICS code to assign to ITES-2S. As previously discussed and stated in the FAR and C.F.R., primary consideration must be given to the principle purpose of the services to be acquired and the services accounting for the greatest percentage of the contract price. The contracting officer's opinion that smaller sized businesses could not perform the volume of work to be performed under ITES-2S should not have been a factor in selecting the appropriate NAICS code.

Furthermore, we dispute the Assistant Secretary's claim that the selected code's appropriateness was confirmed by ample research. As discussed in this report, the contracting officials stated that they did not review work performed under the prior contract, ITES-EMS3, to determine what task areas were accounting for the greatest percentage of the ITES-EMS3 contract price. Additionally, the contracting office did not provide any evidence to support that sufficient analysis was performed by the contracting office to determine what NAICS code accounted for the greatest percentage of the ITES-2S contract price.

We request the Assistant Secretary of the Army for Acquisition, Logistics, and Technology reconsider his position and provide additional comments to the final report.

**b. Follow Defense Federal Acquisition Regulation Supplement procedures for consolidating contract requirements, or break up the requirements into separate smaller contracts.**

**Management Comments.** The Assistant Secretary of the Army for Acquisition, Logistics, and Technology nonconcur with the recommendation. He stated that specific requirements have not been pre-defined under ITES-2S, requirements are performed at the task order level, the acquisition plan was approved, IT services were not consolidated, and small businesses were not deprived of participation.

**Pre-Defined Requirements.** The Assistant Secretary stated that it is true that the Army did not justify consolidation at the ITES-2S contract level, but because ITES-2S is an IDIQ vehicle with no specific, pre-defined requirements, a consolidation justification is not required by DFARS 207.170-2, "Definitions," at the contract level. The Army stated that DFARS 207.170-2 defines consolidation of contract requirements as:

The use of a solicitation to obtain offers for a single contract or a multiple award contract to satisfy two or more requirements of a department, agency, or activity for supplies or services that previously have been provided to, or performed for, that department, agency, or activity under two or more separate contracts.

The Assistant Secretary stated that DFARS 207.170-3 prohibits agencies from consolidating contract requirements with an estimated total value exceeding \$5.5 million without a determination by the senior procurement executive that the benefits of a consolidation acquisition strategy exceed the benefits of possible

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alternative contracting approaches. The regulation further states that benefits may include costs, quality, acquisition cycle, terms and conditions, and any other benefit.

**Task Order Level.** The Assistant Secretary stated no requirements are actually performed at the contract level and specific requirements were not pre-defined in advance of the issuance of the solicitation. Furthermore, the Assistant Secretary stated that even though DFARS 207.170-2 refers to IDIQ contracts, it has no applicability to a procurement such as ITES-2S that lacks definitized requirements. He also stated that due to the nature of ITES-2S, it was not possible to know in advance, what, if any, requirements would eventually be ordered that had previously been performed under two or more separate contracts. In addition, he stated that it was not known whether consolidated requirements with an estimated total value exceeding \$5.5 million would be ordered under the ITES-2S contracts.

Army officials stated that upon award of the ITES-2S contracts, ordering offices would be conducting task order competitions that do involve actual, specified requirements; therefore, it could be possible that those individual task orders will involve a consolidation of two or more requirements, at which time there could be a consolidation as defined in 10 U.S.C. 2382(c) and DFARS Subpart 207.170. The Assistant Secretary added that the ITES-2S ordering guide and the Army Small Computer Program Web site will include notices that ordering offices are responsible for complying with consolidation procedures prior to the placement of an order under ITES-2S.

**Acquisition Plan Approval.** Army officials contended that prior to the issuance of the ITES-2S solicitation they submitted the acquisition plan for review. During the review, the approach to performing any required justifications for consolidation on an order-by-order basis was specifically addressed with the Assistant Secretary of Defense for Network and Information Integration officials, and authorization to proceed was provided.

**Consolidation of IT Services.** The Assistant Secretary stated that the Inspector General's assertion that the hundreds of Army solicitation notices for IT services identified on FedBizOpps are now consolidated under ITES-2S is incorrect. He contended that Army users are not required to use ITES-2S; therefore, it cannot be assumed that all Army IT services are now consolidated into ITES-2S.

**Small Business.** The Assistant Secretary stated that the award of task orders under ITES-2S will not deprive small businesses with a smaller size standard of appropriate opportunities. He stated that before task orders can be placed under ITES-2S, ordering offices must comply with the DFARS procedures for consolidation. Unless consolidation can be justified, requirements would remain available for satisfaction through alternate contracting strategies to include the award of prime contracts to small businesses.

**Audit Response.** We disagree with the Assistant Secretary's comments. Even though the Assistant Secretary argued that specific requirements have not been pre-defined under ITES-2S, requirements are performed at the task order level,



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the acquisition plan was approved, IT services were not consolidated, and small businesses were not deprived; we maintain that ITES-2S consolidates requirements according to DFARS 207.170.

**Pre-Defined Requirements.** DFARS 207.170 is clearly applicable to the ITES-2S acquisition. The Assistant Secretary did not provide any documentation to support his statement that DFARS 207.170 has no applicability to the ITES-2S procurement, which lacks definitized requirements. Multiple-award, task order contracts, to include ITES-2S, specifically fall under the scope of DFARS Section 207.170. DFARS 207.170 does not give the contracting officer or agency the discretion to determine the applicability of this regulation based on their opinion that ITES-2S has no pre-defined requirements. We agree with the Assistant Secretary's comments for Recommendation 1.a. that the ITES-2S contract has an extremely broad scope. As discussed in this report, the inclusion of an extremely broad scope of work supports our analysis that ITES-2S consolidated contract requirements and ultimately results in ITES-2S being a bundled contract.

We also disagree with the Assistant Secretary's assertions that no requirements are definitized at the IDIQ level. Under an IDIQ contract, it is the specific quantities and times for delivery that are not definitized until task orders are issued. The general types of products and services to be ordered should be defined; furthermore, as in compliance with FAR Section 16.504, the contracting officer should only use an indefinite-quantity contract when a recurring need is anticipated. We do not believe the Army would have allocated a potential of \$20 billion for the ITES-2S procurement unless a recurring need had been identified.

**Task Order Level.** In response to the Assistant Secretary's comment that no requirements are actually performed at the contract level, we disagree. In our view and clearly stated in the ITES-2S Statement of Needs in the acquisition plan, the purpose of the ITES-2S procurement is to fulfill the Army's need for IT services. Additionally, without reasonably defining requirements at the contract level, the Army could not have legitimately calculated the Independent Government Cost Estimate, which estimates hourly rates, hours of performance, and total costs for a multitude of labor categories relating to IT.

**Acquisition Plan Approval.** The Army contended that the ITES-2S acquisition plan, which states that the ITES-2S procurement does not involve consolidating requirements, was approved by the Assistant Secretary of Defense for Networks and Information Integration. However, the September 2, 2005, Assistant Secretary of Defense for Networks and Information Integration Memorandum, authorizing ITES-2S to proceed with the procurement, stated that the Army was authorized to proceed under the condition that the contract guards against undue consolidation. Therefore, the Assistant Secretary cannot contend that the ITES-2S contract does not consolidate requirements based on an approved acquisition plan by the Office of the Assistant Secretary of Defense for Network and Information Integration.

**Consolidation of IT Services.** Although Army users are not required to utilize ITES-2S, many Army users that have contracted for IT services under

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smaller contracts will use ITES-2S to fulfill their needs for IT services. Therefore, the Assistant Secretary cannot contend that ITES-2S does not consolidate contract requirements only because the contract vehicle is not mandatory for Army users. There is nothing included in the DFARS that states that mandatory use is a requirement for consolidation. Additionally, the Assistant Secretary acknowledged that the report stated that all requirements for IT services were consolidated into one requirement under ITES-2S; however, he stated that it cannot be assumed that all Army IT services are now consolidated. We did not intend to indicate that *all* Army IT services were consolidated, but were referring to the “full spectrum of enterprise requirements” required to be fulfilled by the ITES-2S contract, as stated in the “DD2579, Small Business Coordination Record, ITES-2S,” March 19, 2005.

**Small Business.** We do not agree with the Assistant Secretary’s statement that the award of task orders under ITES-2S will not deprive small businesses with a smaller size standard of appropriate opportunities. The most appropriate small business size standard for ITES-2S was for a small business with \$23 million in annual receipts. The ITES-2S contracting officials stated in a memorandum that small businesses with annual receipts of \$21 million or below could not provide the depth of task areas required to cover a full spectrum of enterprise requirements. Therefore, it was determined that the ITES-2S requirements were too broad for small businesses to perform, even though they could provide a portion of the requirements. When the requirements under ITES-2S were consolidated, the scope of work became too broad for appropriately qualified small businesses to successfully compete.

**Consolidation Justification.** ITES-2S clearly consolidates contract requirements, and as in accordance with DFARS, justification is required. The Assistant Secretary stated the ITES-2S is an IDIQ vehicle with no specific, pre-defined requirements; therefore, a consolidation justification is not required by DFARS 207.170-2 at the contract level. However, this contradicts the Assistant Secretary’s decision to justify consolidation for the World-Wide Satellite Systems Program, another similar IDIQ vehicle. In the Assistant Secretary’s memorandum, “Determination for the Consolidation of Contract Requirements for the World-Wide Satellite Systems Program,” October 4, 2005, consolidation of contract requirements for the World-Wide Satellite Systems Program was necessary and justified pursuant to DFARS 207.170. Therefore, for the World-Wide Satellite Systems Program, the Assistant Secretary considered DFARS 207.170 applicable, even though the contract is also an IDIQ vehicle. .

We request the Assistant Secretary of the Army for Acquisition, Logistics, and Technology reconsider his position and provide additional comments to the final report.

**c. Justify the contract bundling.**

**Management Comments.** The Assistant Secretary of the Army for Acquisition, Logistics, and Technology, responding for the Director, Army Contracting Agency, nonconcurred with the recommendation. The Assistant Secretary disagreed because the ITES-2S contract is not consolidated, bundling determination applies at the task order level, GAO Competition and Contracting

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Act rulings justify consolidation, and small businesses did not receive a competitive disadvantage.

**Consolidation.** The Assistant Secretary contended that ITES-2S is not a bundled contract because ITES-2S does not consolidate contract requirements. The Assistant Secretary stated that “bundling” is defined as consolidating two or more requirements for supplies or services, previously provided or performed under separate smaller contracts, into a solicitation for a single contract that is likely to be unsuitable for award to a small business concern due to factors that are described in the regulation. The Assistant Secretary stated that FAR Part 2.101 and FAR 7.107 provide regulations for the acquisition of bundled requirements. According to the Assistant Secretary, FAR Part 7.107(b) states that the

Benefits may be deemed sufficient to justify bundling if the benefits to be derived from the bundling, after comparison with the benefits if requirements are not bundled, are equivalent to, (1) ten percent of the estimated contract or order value (including options) if the value is \$86 million or less, or (2) five percent of the estimated contract or order value (including options) or \$8.6 million, whichever is greater, if the value exceeds \$86 million.

In addition, the Assistant Secretary stated that FAR Part 7.107(g) provides that in assessing whether cost savings would be achieved through bundling, the contracting officer must consider the cost that has been charged or, where data is available, could be charged by small business concerns for the same or similar work.

The Assistant Secretary added that FAR Part 2.101 defines “bundling” in terms of a solicitation that is likely to be unsuitable for award to a small business concern. According to the Assistant Secretary, the ITES-2S procurement does not meet this regulatory standard, because the procurement was determined to be suitable for performance by small business, and a number of small business concerns submitted proposals. Ultimately, awards were made to five offerors deemed to be small businesses by the SBA.

The Assistant Secretary reiterated his position that the ITES-2S contract did not constitute consolidation under the bundling requirements because specific requirements were not pre-defined at the contract level. He added that absent these requirements it is not possible to determine whether requirements have been performed under separate smaller contracts, nor is it feasible to quantify and compare the benefits from performing a bundled effort with the benefits from performing the same or similar work when not bundled.

**Task Order Level.** The Assistant Secretary stated that under the ITES-2S contract procurement work will be specified at the task order level, and that this is the appropriate time for the application of the bundling regulation in a procurement such as ITES-2S. He added that procedures are being finalized to ensure compliance at the task order level with the regulations governing small business bundling.

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**GAO.** The Assistant Secretary stated that even if the previous arguments that the requirements are not bundled are rejected, there is justification for the consolidation consistent with GAO Competition on Contracting Act rulings, based on mission requirements. He stated that solutions under ITES-2S must be “uniform” in order to mitigate risks in conjunction with disruption and delay of wartime operations. He concluded that having a single contract with limited vendors is the way to ensure uniformity.

**Small Business – Memorandum Comments.** In his January 17, 2007, memorandum, the Assistant Secretary stated that any small business could have submitted a proposal, but the Army did not receive proposals from any small business that would have qualified as small under a more restrictive size standard. The Assistant Secretary concluded that these smaller businesses were not placed at “any competitive disadvantage.” Therefore, since any small business could have competed for the ITES-2S procurement, there is no basis to conclude that there was improper bundling, or that a justification for bundling was required.

**Audit Response.** We disagree with the Assistant Secretary’s comments. Although the Assistant Secretary denied that the contract was bundled because the ITES-2S contract is not consolidated, bundling determination applies at the task order level, GAO Competition and Contracting Act rulings justify consolidation, and small businesses did not receive a competitive disadvantage; we have previously illustrated in this report how ITES-2S meets the entire criterion for a bundled contract.

However, we revised Recommendation 1.c. because it is no longer reasonable for the U.S. Army to re-compete the ITES-2S base contract. We request that the Assistant Secretary of the Army for Acquisition, Logistics, and Technology provide comments to the revised recommendation in response to the final report.

**Consolidation.** As discussed previously, we take exception with the Assistant Secretary’s assessment that ITES-2S does not consolidate contract requirements and have illustrated how, through contract consolidation and selecting an incorrect NAICS code, the ITEC4 contract officials bundled the ITES-2S contract, resulting in a contract that was unsuitable for appropriate small business prime contract awards.

We agree that, according to FAR Part 7.107, benefits may be deemed sufficient to justify bundling; however, the ITES-2S contracting officials did not provide a benefits analysis or other justification for bundling the ITES-2S contract. This report has provided the requirements and basis of a bundled contract per FAR Subpart 2.1. The Army assigned an incorrect NAICS code to the ITES-2S contract and the contracting officials improperly awarded small business reserves to businesses not categorized as small per the appropriate NAICS code.

We disagree that the ITES-2S contract did not constitute consolidation because specific requirements were not pre-defined at the contract level. As previously stated, DFARS 207.170, “Consolidation of Contract Requirements,” is applicable to the ITES-2S acquisition. Multiple-award task order contracts, to

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include ITES-2S, specifically fall under the scope of DFARS 207.170. DFARS 207.170 does not give the contracting officer or agency the discretion to determine the applicability of this regulation based on their opinion that ITES-2S has no pre-defined requirements.

**Task Order Level.** FAR Part 2.101 states that multiple-award, IDIQ contracts fall under the definition of a “single contract.” Therefore, bundling regulation is applicable to ITES-2S at the IDIQ contract level. We disagree with the Assistant Secretary’s statement that the task order level is the most appropriate time for applying bundling regulations.

**GAO.** We asked the Office of the Assistant Secretary of the Army for clarification on which specific GAO Competition in Contracting Act rulings he was referring to that justified consolidation, but did not receive a response. Through reviewing prior audit coverage, we discovered GAO case, “Phoenix Scientific Corporation, B-286817,” February 22, 2001, which is similar to the ITES-2S procurement. In the Phoenix Scientific Corporation case, GAO denied a protest alleging that the Air Force had improperly bundled a solicitation for a multiple-award task order contract. GAO concluded that the procurement was not a consolidation that would result in a contract unsuitable for award to a small business concern. However, unlike the ITES-2S contract, the Air Force selected the appropriate small business size standard. The ITES-2S contracting officials did not follow FAR requirements in selecting an appropriate small business size standard. Therefore, this GAO Competition in Contracting Act ruling cannot be used as precedence for consolidation justification for the ITES-2S contract. Also, as stated previously in the report, if the correct code had been chosen for the ITES-2S acquisition, true small businesses would have been eligible for the contract and therefore, the contract would not have been bundled.

**Small Business – Memorandum Comments.** We disagree with the Assistant Secretary’s comment in the January 17, 2007, memorandum that any small business could have competed for the ITES-2S contract; therefore smaller businesses were not placed on any competitive disadvantage. Even though small businesses were provided the opportunity to place a bid on the ITES-2S contract, this does not equate to ITES-2S being suitable for small business award. Although these smaller businesses could have submitted a bid, as previously mentioned, the contracting office had already determined that these smaller businesses could not perform the volume of work under ITES-2S, and they ultimately had no chance of winning a prime contract. Therefore, it was incorrect to say that these smaller businesses were not placed at “any competitive disadvantage.” In reality these smaller businesses had little chance to compete for award. The FAR defines “bundling” as the consolidation of two or more requirements for supplies or services, previously provided or performed under separate smaller contracts, into a solicitation for a single contract that is likely to be unsuitable for award to a small business concern. Small businesses under the size standard of \$23 million in average yearly revenue were precluded from competing for ITES-2S prime contract awards. However, these small businesses represented the appropriate-sized small businesses as per an appropriate NAICS code. Therefore, since ITES-2S was unsuitable for award to appropriate-sized small businesses, ITES-2S is a bundled contract.

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Furthermore, even though it was determined by contracting officials that smaller small businesses could not meet enterprise requirements, these smaller small businesses could have performed portions of the requirements. However, the contracting office decided not to set aside any portion of the work under ITES-2S just for small business competition. The contracting office determined not to utilize a partial small business set-aside as described in FAR Subpart 19.5, “Set-Asides for Small Business.”

We request the Assistant Secretary of the Army for Acquisition, Logistics, and Technology reconsider his position and provide additional comments to the revised recommendation in the final report.

**2. We recommend that the Director, Army Small and Disadvantaged Business Utilization develop a standardized contract review process for small business that verifies compliance with the Federal Acquisition Regulation requirements.**

**Management Comments.** The Assistant Secretary of the Army for Acquisition, Logistics, and Technology, responding for the Director, Army Small and Disadvantaged Business Utilization, concurred.

**Audit Response.** The comments were responsive to the recommendation.

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## Appendix A. Scope and Methodology

We conducted this performance audit from March 2006 through June 2007 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The scope of this audit was limited to a review of the ITES-2S acquisition. Specifically, we determined whether the ITES-2S contract was consistent with Federal and DoD acquisition policy, to include information assurance requirements.

We interviewed and obtained documentation from the staffs of the Program Executive Office-Enterprise Information Systems; ITEC4; Army Contracting Agency; Army Small Computer Program Office; Office of the Secretary of Defense, Networks and Information Integration; SBA; and Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics (Defense Procurement and Acquisition Policy).

We obtained information for the audit through meetings and e-mails with the personnel above. We reviewed and analyzed laws, policies, guidance, and documentation dated from February 1996 through October 2006. Specifically, we reviewed and compared:

- FAR Part 10, “Market Research,” February 12, 2007; FAR Part 11, “Describing Agency Needs,” September 28, 2006; FAR Subpart 19.1, Section 19.102, “Size Standards,” September 28, 2006; FAR Subpart 19.2, Section 19.201, “General Policy,” September 28, 2006; C.F.R. Title 13, Chapter 121, “Small Business Size Regulations,” Sections 121.101 a, 121.402 b, 121.407, and 121.410, January 1, 2006; ITES-2S Acquisition Plan, May 24, 2005; and ITES-2S Solicitation, October 7, 2005, for the small business concern.
- Title 10, United States Code, chapter 141, section 2382, “Consolidation of contract requirements: policy and restrictions,” January 3, 2005; DFARS Section 207.170, “Consolidation of contract requirements,” March 21, 2006; Deputy Secretary of Defense Memorandum, “Consolidation of Contract Requirements,” October 28, 1996, for consolidation of requirements.
- FAR Subpart 2.1, “Definitions of Words and Terms,” September 28, 2006; Department of Defense, Office of Small and Disadvantaged Business Utilization, Benefit Analysis Guidebook; ITES-2S Acquisition Plan, May 24, 2005; and ITES-2S Solicitation, October 7, 2005, for bundling determination.

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- DoD Directive 8500.1, “Information Assurance,” October 24, 2002; DoD Instruction 8500.2, “Information Assurance Implementation,” February 6, 2003; DoD Instruction 8580.1, “Information Assurance in the Defense Acquisition System,” July 9, 2004; and ITES-2S Solicitation, October 7, 2005, for Information Assurance compliance.
  - Title 44, United States Code, chapter 35, section 3502, “Definitions,” January 26, 1998; Defense Acquisition Guidebook Guidance for the Clinger-Cohen Act of 1996, July 12, 2006; DoD Instruction 5000.2, “Operation of the Defense Acquisition System,” May 12, 2003; Clinger-Cohen Act of 1996, Division E of Public Law 104-106, February 10, 1996; Acquisition, Technology, and Logistics Memorandum, “Acquisition of Services,” May 31, 2002; Acquisition, Technology, and Logistics Memorandum, “Acquisition of Services Policy,” October 2, 2006; ITES-2S Acquisition Plan, May 24, 2005; and ITES-2S Solicitation, October 7, 2005, for compliance with the Clinger-Cohen requirements.

**Use of Computer-Processed Data.** We did not use computer-processed data to perform this audit.

**Use of Technical Assistance.** The Technical Assessment Directorate of the DoD Inspector General reviewed Section C, Statement of Objectives of the ITES-2S contract and concluded that all Federal Government and DoD Information Assurance policies were met. Specifically, the Technical Assessment Directorate compared Section C, Statement of Objectives of the ITES-2S contract to the information assurance requirements identified in Federal and DoD policy. They found that the ITES-2S contract did incorporate the requirements identified in directives, instructions, and guides to ensure information assurance of system and networks.

**Government Accountability Office High-Risk Area.** GAO has identified several high-risk areas in DoD. This report provides coverage of the Protecting the Federal Government’s Information Systems and the Nation’s Critical Infrastructures and the Management of Interagency Contracting high-risk areas.

## Prior Coverage

No prior coverage has been conducted on the ITES-2S contract during the last 5 years.



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## Appendix B. Other Matters of Interest

### ITES-2H NAICS Code Selection

Although the ITES-2H contract was not within the scope of this audit, while performing our audit of the ITES-2S contract, we identified the following concerns about the ITES-2H contract: ITEC4 contracting officials did not follow FAR procedures in assigning a NAICS code to the ITES-2H solicitation, and as a result, appropriately qualified small businesses may not have had fair opportunity to compete for ITES-2H small business reserve awards.

**ITES-2H Background.** On August 22, 2006, Army's ITEC4 contracting officials released the solicitation for its ITES-2H contracts. ITES-2H is a \$5 billion multiple-award, IDIQ contract that stipulates awarding contracts to seven contractors with two awards being reserved for small businesses.

The ITES-2H solicitation states that the fundamental purpose of the ITES-2H acquisition is to support the Army enterprise infrastructure and infostructure goals with a full range of innovative, world-class IT equipment and solutions at a reasonable price. Contractors are to provide for

the purchase and lease of commercial RISC/EPIC servers, Intel/AMD servers, desktops, notebooks, workstations, thin clients, storage systems, networking equipment (including wireless), network printers, product ancillaries (including equipment cabinets, racks and mounts), peripherals (including monitors), network cabling products, video teleconferencing (VTC) products, standalone displays (e.g., plasma screens, HDTVs), scanners, Everything over Internet Protocol (EoIP) products, communications devices, power devices, software, basic warranty and warranty options, and other related accessories and options.

The contractors also must provide related fixed-price services that enable the capability to provide end-to-end equipment solutions. However, services must be directly related to the procurement of equipment under ITES-2H.

**NAICS Code Selection.** The ITES-2H solicitation was assigned the NAICS code 517110, "Wired Telecommunications Carriers." This is the same code assigned to the ITES-2S solicitation even though ITES-2S is predominantly for the acquisition of services and ITES-2H is predominantly for the acquisition of hardware.

FAR Subpart 19.102 states that small business size standards are applied by classifying the product or service being acquired in the industry, whose definition, as found in the NAICS manual, best describes the principal nature of the product or service being acquired. Therefore, contracting officials should have assigned the ITES-2H solicitation a NAICS code whose definition best describes the industry that manufactures, sells, and leases IT hardware and equipment.

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The NAICS manual defines “Wired Telecommunications Carriers” as the industry engaged in operating and maintaining switching and transmission facilities to provide point-to-point communications via landlines, microwave, or a combination of landlines and satellite linkups, or furnishing telegraph and other non-vocal communications using their own facilities. The definition for “Wired Telecommunications Carriers” does not remotely describe an industry that manufactures, sells, and leases IT hardware and equipment. The following codes within the NAICS manual better describe the principle nature of what is to be acquired under ITES-2H:

- 423430, “Computer and Computer Peripheral Equipment and Software Merchant Wholesalers;”
- 334111, “Electronic Computer Manufacturing;”
- 334112, “Computer Storage Device Manufacturing;”
- 334113, “Computer Terminal Manufacturing;” and
- 334119, “Other Computer Peripheral Equipment Manufacturing.”

The NAICS manual defines “Computer and Computer Peripheral Equipment and Software Merchant Wholesalers” as the industry that comprises establishments primarily engaged in the merchant wholesale distribution of computers, computer peripheral equipment, loaded computer boards, and computer software. The NAICS manual describes NAICS section 33411, “Computer and Peripheral Equipment Manufacturing,” which includes the NAICS codes 334111, 334112, 334113, and 334119, as the industry that comprises establishments primarily engaged in manufacturing and assembling electronic computers, such as mainframes, personal computers, workstations, laptops, and computer servers; and computer peripheral equipment, such as storage devices, printers, monitors, input/output devices, and terminals. These codes specifically relate to the acquisition of IT hardware and equipment, and therefore, best describe the principle nature of what is to be acquired under ITES-2H. However, ITES-2H contracting officials did not follow FAR requirements when they selected a NAICS code that does not best describe the principle nature of the products being acquired.

**Size Standards and Small Business Participation.** NAICS code 517110, “Wired Telecommunications Carriers,” has an associated small business size standard of 1,500 employees. Codes that best describe the products to be acquired under ITES-2H have small business size standards of 1,000 employees and less. Since contracting officials assigned NAICS code 517110 to the ITES-2H solicitation, businesses can qualify as small if they have 1,500 employees or less. However, if an appropriate code was assigned to ITES-2H, businesses would be considered large if they had more than 1,000 employees. As a result, appropriately qualified small businesses with 1,000 employees or less may have to compete with businesses that have over 1,000 employees for ITES-2H small business reserve awards, and would not be considered small if the appropriate NAICS code was chosen.

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## **Appendix C. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition, Technology, and Logistics  
    Director, Defense Procurement and Acquisition Policy  
Under Secretary of Defense (Comptroller)/Chief Financial Officer  
    Deputy Chief Financial Officer  
    Deputy Comptroller (Program/Budget)  
Assistant Secretary of Defense for Networks and Information Integration/DoD Chief  
    Information Officer  
Director, Program Analysis and Evaluation

### **Department of the Army**

Assistant Secretary of the Army for Acquisition, Logistics, and Technology  
Assistant Secretary of the Army (Financial Management and Comptroller)  
Auditor General, Department of the Army  
Director, Army Contracting Agency  
    Director, Information Technology, E-Commerce, and Commercial Contracting Center  
Program Executive Officer, Enterprise Information Systems  
    Project Manager, Army Small Computer Program  
Director, Small and Disadvantaged Business Utilization Office

### **Department of the Navy**

Naval Inspector General  
Auditor General, Department of the Navy

### **Department of the Air Force**

Auditor General, Department of the Air Force

### **Combatant Command**

Inspector General, U.S. Joint Forces Command

### **Non-Defense Federal Organizations and Individuals**

Office of Management and Budget  
U.S. Small Business Administration

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## **Congressional Committees and Subcommittees, Chairman and Ranking Minority Member**

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Homeland Security and Governmental Affairs  
Senate Committee on Small Business and Entrepreneurship  
House Committee on Appropriations  
House Subcommittee on Defense, Committee on Appropriations  
House Committee on Armed Services  
House Committee on Oversight and Government Reform  
House Subcommittee on Government Management, Organization, and Procurement,  
Committee on Oversight and Government Reform  
House Subcommittee on National Security and Foreign Affairs,  
Committee on Oversight and Government Reform  
House Committee on Small Business

# Department of the Army Comments



DEPARTMENT OF THE ARMY  
OFFICE OF THE ASSISTANT SECRETARY OF THE ARMY  
ACQUISITION LOGISTICS AND TECHNOLOGY  
103 ARMY PENTAGON  
WASHINGTON DC 20310-0103

02 MAY 2007

SAAL-PP

MEMORANDUM FOR OFFICE OF THE INSPECTOR GENERAL, DEPARTMENT OF  
DEFENSE, ATTN: MS. JACQUELINE L. WICECARVER,  
PROGRAM DIRECTOR, ACQUISITION AND CONTRACT  
MANAGEMENT, 400 ARMY NAVY DRIVE, ARLINGTON,  
VA 22202

SUBJECT: Information Technology Enterprise Solutions (ITES-2) Services Contracts

References:

- a. DODIG letter dated December 8, 2006, to ASA(ALT), subject: same as above.
- b. ASA(ALT) response to DODIG, letter dated January 17, 2007, subject: same as above.
- c. DODIG Draft Report No. D2006-D000AS-0173.000, February 28, 2007.

I am writing in response to your recent report dated February 28, 2007, wherein you request that the U.S. Army revise North American Industry Classification System code (NAICS) assigned to the ITES-2 contract to an appropriate code as defined in the NAICS manual and modify or re-compete the ITES-2 contract requirements in order to allow appropriate small business participation. In addition, you recommended that the Director, Army Small and Disadvantaged Business Utilization, develop a standardized contract review process to ensure small businesses participation to the fullest extent.

The U.S. Army is convinced that all actions taken by the Information Technology E-Commerce and Commercial Contracting Center and the Army Office of Small Business Programs (OSBP) to ensure that the ITES-2 Services Contracts support the purposes of the Small Business Act by promoting small business participation are correct. In addition, the Army OSBP intends to implement recommendation #2.

Provided at the enclosure to this memorandum are detailed responses to the issues addressed in your report referenced at paragraph c above.

Claude M. Bolton, Jr.

Assistant Secretary of the Army  
(Acquisition, Logistics and Technology)

Enclosure

**Recommendation 1.a.** Revise the North American Industry Classification System code assigned to the Information Technology Enterprise Solutions-2S Services contract to an appropriate code defined in the North American Industry Classification System manual under section 54151, "Computer Systems Design and Related Services."

**Army nonconcurs with the recommendation.**

The Army nonconcurs with the recommendation for various reasons, as discussed below.

a. The Report correctly notes, at page 6, that size standards are applied by classifying the product or service being acquired in the code for the industry that "best describes the principal nature of the product or service" and that contracting officers are to apply the size standard for the industry accounting for the "greatest percentage of the contract price" when the product or service could be classified in two or more industries.... FAR 19.102(b) (1) and (d). That poses a challenge for large Indefinite Delivery, Indefinite Quantity vehicles such as ITES-2S, which are extremely broad in scope and have no defined requirements until individual task orders are placed. The Army can only make its best estimate of the work that will be performed. In this procurement, the Army's contracting officer chose a code based upon a number of legitimate considerations, selecting NAICS code 517110 "Wired Telecommunications Carriers."

At page 10, the Report indicates that Contracting Officials selected the code solely for the purpose of obtaining a preferred size standard "that would allow the most liberal small business threshold" and without considering the nature of the work. That is not correct. In her NAICS code determination memorandum, the contracting officer expressed familiarity with the same applicable regulation governing NAICS codes noted by the DOD IG in the Report and she clearly considered the nature of the work in making her decision on the appropriate code.

In a memorandum by the contracting officer, dated 8 March 2005, subject: "North American Industry Classification System (NAICS) Code Determination for Information Technology Enterprise Solutions-2 Services (ITES-2S)", the contracting officer referenced the applicable provisions of FAR 19.102. The memorandum includes references to the ITES-2S work and the consideration of that work in choosing the NAICS code. Paragraph 3 provides:

The objective of this acquisition is to provide a full range of services and solutions necessary for the Army to satisfy its support of the Army enterprise infrastructure and infrastructure goals with information technology (IT) services worldwide. The scope includes Command, Control, Communications, Computers, and Information Management (C4IM) requirement as defined in Army Regulation (AR 25-1). This includes obtaining end-to-end solutions support to satisfy worldwide development, deployment, operation, maintenance and sustainment requirements for the Army.

In paragraph 5, the contracting officer compared the ITES-2S work to NAICS codes 541519 and 517110. The memorandum notes that no single code covers the "complexity" of the ITES-2S acquisition. It states that "NAICS code 541519 covers only a portion of the requirement." It further compares the ITES-2S effort to NAICS code 517110 and concludes that that code "best describes the makeup of this acquisition" because the code parallels the basic function of the acquisition. Specifically, the memorandum states:

NAICS code 517170 focuses on firms engaged in furnishing point-to-point communications services (voice and data), which parallels the basic function of this requirement as described above. Therefore, the NAICS code that best describes the makeup of the acquisition is 517110.

While it is true that there is a reference in the memorandum to the fact that the chosen code allows the most liberal small business size standard, that comment is neither inappropriate nor does it demonstrate a failure by the contracting officer to consider the nature of the work in making her determination. In fact, the documentation clearly indicates that the contracting officer considered the nature of the work in choosing the NAICS code for ITES-2S.

At page 7 of the Report, it is maintained that the code selected by the contracting officer was inappropriate for the effort under ITES-2S. In support of this position, the Report makes certain assertions, at pages 8 and 11, based upon a selective consideration of acquisition documentation that reveal the IG has misconstrued the nature of the requirement. For example, the Report notes that the procurement is "predominantly for services", that hardware and software are "incidental", that the "vast majority" of costs in the Independent Government Cost Estimate (IGCE) are "related to IT services," and "that systems will not be acquired through the ITES-2S contract vehicle."

While services are unquestionably an essential component, ITES-2S is not simply procurement for IT services. Nor is the acquisition of equipment an insignificant aspect of this procurement. The purpose of ITES-2S is to obtain a procurement vehicle consisting of multiple contracts that can support the Army infrastructure and infostructure goals with enterprise solutions that include the provision of both IT services and related equipment to provide end-to-end solutions worldwide. As an IDIQ contract vehicle involving requirements that will be definitized only at the task order level, the ITES-2S contracts themselves do not represent "system" procurements, but the provision of total solutions under ITES-2S at the task order level is a fundamental objective of the procurement.

There are multiple references in the Acquisition Plan that emphasize the need for end-to-end solutions that include equipment as well as services. Awardees are responsible not only for providing IT services but for providing a "full range of IT hardware and software, which allow end-to-end solutions....". In concert with the purpose of the acquisition to be a vehicle for enterprise solutions, the procurement of IT equipment under ITES-2S must be "related to the acquisition of the services." In that sense, the

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equipment is incidental, but that fact does not nullify the essential importance of the equipment to the provision of end-to-end solutions. The centrality of solutions to the nature of the procurement is underscored by the fact that the non-labor, solution-based costs in the IGCE, which include costs for equipment and other items, represent a robust 39% of total costs. As noted above, the procurement of equipment for solutions will always be connected to the procurement of related services. Thus, the total cost of solutions, including the labor that is not encompassed by the 39 percent figure, would, of course, be even greater.

On page 10, the Report notes that the contracting officer relied upon an SBA notice entitled "Standard Industrial Classification (SIC) 4813 Clarification, although it had expired. While it is true that the notice has expired, SIC code 4813 is the predecessor to NAICS code 517110, and the notice provides insight into the view of the Small Business Administration on the scope of the code. Significantly, the notice makes clear that the code is appropriate for services that comprise disciplines in various SIC codes and that it encompasses providing equipment as well as services.

At page 8 of the Report, the DOD IG dismisses the selected code as applying only to "telephone companies such as AT&T." In fact, however, as the Contracting Officer states in her memorandum, the code is broader than the IG suggests. Due to the broad scope of ITES-2S, there is no single NAICS code which would encompass all of the work to be performed under ITES-2S. The contracting officer selected the code based upon various legitimate considerations, and her determination was confirmed, prior to the issuance of the solicitation, by the SADBUs of both the Army and DOD, and by the SBA itself. Moreover, the Senate and House Small Business Committee staffs were briefed on the selected NAICS code without a negative response.

b. According to applicable regulation, the type of work to be performed under the contract is an important consideration in choosing a NAICS code, but it is not the only consideration. Rather, SBA's regulations state that "[o]ther factors considered include previous Government procurement classifications of the same or similar products or services, and the classification which would best serve the purposes of the Small Business Act." 13 CFR § 121.402(b). In the case of ITES-2S, the Army identified numerous acquisitions similar in size and scope to ITES-2S that have utilized NAICS code 517110. These include the Air Force's Network-Centric Solutions (NETCENTS) contracts, Communications-Electronics Life Cycle Management Command's Total Engineering and Integration Services (TEIS) I and II contracts, and ITES-EMS3, the predecessor to ITES-2S.

As previously explained in the January 17<sup>th</sup> memorandum to the IG, the chosen code also "best serve[s] the purposes of the Small Business Act." Specifically, the Army's contracting officer concluded, through market research, that "smaller" sized small businesses could not perform the enterprise-wide services desired under ITES-2S. The chosen code did not preclude any "smaller" sized companies from submitting proposals, but merely permitted "larger" sized companies to qualify as "small" businesses for



purposes of this acquisition. In other words, the code fosters participation by small businesses reserving some prime contracts for small businesses.

In light of the plain language of 13 CFR § 121.402(b), it is unquestionably appropriate for a contracting officer to consider matters beyond the type of work to be performed under the contract when selecting a NAICS code. In the case of ITES-2S, the "other factors" identified in SBA's regulations support use of the chosen code. By ignoring these other considerations and focusing exclusively on the type of work, the DOD IG's analysis runs counter to the regulation.

c. The SBA's regulations further provide that "[t]he NAICS code assigned to a procurement and its corresponding size standard is final unless timely appealed to SBA's Office of Hearings and Appeals (OHA), or unless SBA assigns an NAICS code or size standard [as a result of a complaint to SBA]." 13 CFR § 121.402(c). The obvious intent of the rule is to ensure that any dispute over a choice of NAICS code is raised, and resolved, early in the process, before offerors and the Government devote significant resources to the procurement. In the case of ITES-2S, no challenge was ever filed against the choice of NAICS code, nor did any companies otherwise voice dissatisfaction with the Army's choice of code. The NAICS code for ITES-2S became final, and not subject to further review, as of September 2005. Offerors had ample notice of the code that had been selected for the procurement. Prior to the release of the final solicitation in September 2005, the code had been identified in announcement published in January 2005 as part of the advisory multi-step process conducted in the ITES-2S procurement and again in July 2005 as part of a draft solicitation. The recommendation to revise the code at this late date is inconsistent with the spirit and intent of SBA's NAICS code review process.

d. The Army's choice of code did not preclude "smaller" sized companies from submitting proposals. Rather, the code merely established an upper limit for how large a company could be in order to be considered "small." Prime contracts were awarded to five companies deemed to be small business by the SBA under the size standard for the NAICS code that was selected for the ITES-2S procurement. Although the Army did not receive any proposals from small businesses that have qualified under a lesser size standard, small businesses that would have qualified under such a standard were not precluded from submitting proposals, nor from partnering with other companies (e.g., creating a joint venture composed of several small businesses) in order to compete for ITES-2S prime contracts. Thus, the IG's assertion that the choice of NAICS code was somehow detrimental to such small businesses is not well-founded.

Not only was the ITES-2S strategy not detrimental to small businesses, it included significant and impressive minimum mandatory small business subcontracting goals. The solicitation required offerors to guarantee overall small business participation of 25 percent of dollars awarded. The solicitation further required the offerors to identify their small business teaming partners and the extent of commitment to use the firms. The 25 percent for small business participation equates to a potential of \$5 billion geared towards small businesses based upon the contract maximum of \$20 billion. The mandatory goal

is a guarantee for the small business community. Individual ITES-2S awardees have no guarantee of success at the task order competition level. Theoretically, a prime contract awardee might have no or limited success in competing for tasks. However, the mandatory small business participation goal for subcontracting means that there is a definitive amount designated for small businesses for every dollar awarded under the contract.

**Recommendation 1.b.** Follow Defense Federal Acquisition Regulation Supplement procedures for consolidating contract requirements, or break up the requirements into separate smaller contracts.

**Army nonconcurs with the recommendation.**

Army contracting officials did not improperly fail to justify consolidating contract requirements in the ITES-2S procurement. It is true that the Army did not justify consolidation at the ITES-2S contract level. However, ITES-2S is an indefinite delivery/indefinite quantity "IDIQ" vehicle with no specific, pre-defined requirements. Under these circumstances, a consolidation justification is not required by DFARS 207.170-2 at the contract level. As part of the process for the oversight of services governed by AFARS Subpart 5137.5, the Office of the Assistant Secretary of Defense for Networks and Information Integration (OASD NII) concurred with the Army's acquisition strategy, which included the absence of a consolidation justification at the contract level, and further suggested that the Army establish procedures to ensure compliance at the task order level with the DFARS regulations governing consolidation; these procedures are in the process of being finalized.

Under an IDIQ contract vehicle such as ITES-2S, work is performed on the basis of individual task orders. As stated in FAR 16.504(a) with respect to an IDIQ contracting approach, "[t]he Government places orders for individual requirements." No requirements are actually performed at the contract level. Requirements are specified and performed in conjunction with the issuance of particular task orders.

The ITES-2S contracts provide only a general source of contractual support for requirements within a broad contract scope. Specific requirements to be satisfied under ITES-2S were not pre-defined in advance of the issuance of the solicitation. In this procurement, it was contemplated that specific requirements would not be defined until requiring activities requested the issuance of task orders. In short, ITES-2S had no definitive requirements that could have been analyzed for consolidation purposes during acquisition planning; such requirements would only arise after award in conjunction with the issuance of particular task orders.

DFARS 207.170-2 defines "[c]onsolidation of contract requirements" as "the use of a solicitation to obtain offers for a single contract or a multiple award contract to satisfy two or more requirements of a department, agency, or activity for supplies or services that previously have been provided to, or performed for, that department, agency, or

activity under two or more separate contracts.” DFARS 270.170-3 prohibits agencies from consolidating “contract requirements with an estimated total value exceeding \$5.5 million...” without a determination by the senior procurement executive that the benefits of a consolidation acquisition strategy exceed the benefits of possible alternative contracting approaches. The regulation further states that benefits may include costs, quality, acquisition cycle, terms and conditions, and any other benefit.

The ITES-2S requirement does not meet the regulatory requirements for a consolidation justification at the contract level. Even though the regulation on consolidation procedures at DFARS 270.170-2 refers to IDIQ contracts, it has no applicability to a procurement such as ITES-2S which lacks definitized requirements. Due to the nature of the ITES-2S procurement, it was not possible to know in advance, what, if any, requirements would eventually be ordered that had previously been performed under two or more separate contracts. Likewise, it was not known whether consolidated requirements with an estimated total value exceeding \$5.5 million would be ordered under the ITES-2S contracts. Unlike some solicitations for IDIQ contracts, the ITES-2S solicitation included no defined requirements. Without defined requirements, it was not possible to analyze whether the benefits from a consolidated approach outweigh the benefits from alternative contracting approaches.

The Army has always recognized that, upon award of the ITES-2S contracts, ordering offices would be conducting task order competitions that do involve actual, specified requirements. It is possible that those individual task orders will involve a consolidation of two or more requirements, at which time there could be a “consolidation” as defined in 10 USC § 2382(c) and DFARS Subpart 207.170. To address this situation, the ITES-2S ordering guide and the Army Small Computer Program it-eMart web site will include notices that ordering offices are responsible for complying with the above-referenced DFARS consolidation procedures prior to the placement of an order under ITES-2S.

The position of the Army on consolidation was set forth in the Acquisition Plan for ITES-2S. Prior to the issuance of the ITES-2S solicitation, the Army submitted the Plan for review pursuant to the applicable regulations that govern the oversight of services. As part of that process, the approach to performing any required justifications for consolidation on an order-by-order basis was specifically addressed with OASD NII officials, and authorization to proceed was provided.

It is noted, on page 5 of the Report, that there is an assertion that requirements are being consolidated under ITES-2S because the IG reportedly identified “hundreds of Army solicitation notices” for information technology (IT) services on FedBizOpps prior to the award of ITES-2S. According to the Report, such requirements are “now consolidated under ITES-2S.” That conclusion is simply incorrect. Army users are not required to use ITES-2S for all IT services acquisitions. Rather, Army users may choose to acquire such services through alternate means, such as the Federal Supply Schedule or a small business set-aside. Since Army users are not required to utilize ITES-2S for IT service acquisitions, it cannot be assumed that all Army IT services are now consolidated into ITES-2S.

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The Report indicates, at page 11, that the alleged consolidation of requirements under ITES-2S deprives small businesses with a size standard under \$23 million of the opportunity to compete for prime contract awards. ITES-2S does not, however, consolidate requirements at the contract level. Nor will the award of task orders under ITES-2S deprive small businesses with a smaller size standard of appropriate opportunities. Before task orders can be placed under ITES-2S, ordering offices must comply with the DFARS procedures for consolidation. Unless consolidation can be justified, requirements would remain available for satisfaction through alternate contracting strategies to include the award of prime contracts to small businesses.

In sum, the Army disagrees that a consolidation justification was required, or even that one could have been performed, at the ITES-2S contract level. Specific requirements have not been pre-defined under ITES-2S, and the Report is incorrect in asserting that requirements were consolidated under this procurement. In the circumstances, the appropriate time for addressing any required consolidation justification is when a user is determining the requirements for a task order under ITES-2S. The Army is in the process of finalizing procedures to ensure that ordering offices comply with the applicable regulation at that time. The approach to consolidation pursued by the Army contracting officials was appropriate for the ITES-2S procurement and does not violate the DFARS procedures on consolidation.

**Recommendation 1.c.** Modify or recomplete the Information Technology Enterprise Solutions-2 Services contract using the correct section 54151 North American Industry Classification System code in order to allow appropriate small business participation, or justify the contract bundling if small business participation is not warranted at the prime contract level.

**Army nonconcurs with the recommendation.**

Modification or recompetition is not warranted based upon small business bundling, as recommended in the Report, because ITES-2S does not consolidate requirements and is therefore not a bundled contract. The Report states, on page 11 and again on page 12, that ITES-2S is a bundled contract. In support of its statement on bundling, the IG employs a flowchart that is derived from the "Department of Defense, Office of Small and Disadvantaged Business Utilization, Benefit Analysis Guidebook". According to the flowchart, a contract is "[n]ot a bundled contract" unless it "[c]onsolidates 2 or more requirements". The Report erroneously concludes that "ITES-2S does consolidate two or more requirements". As addressed elsewhere in these Comments in the context of the DFARS consolidation procedures, ITES-2S does not consolidate requirements. In addition, as discussed below, ITES-2S was not unsuitable for award to small business. Consequently, ITES-2S is not a bundled contract.

Under the applicable regulations, "bundling" is defined as "[c]onsolidating two or more requirements for supplies or services, previously provided or performed under separate smaller contracts, into a solicitation for a single contract that is likely to be unsuitable for

award to a small business concern due to" factors that are described in the regulation. Acquisitions for bundled requirements must be justified by a contracting officer. The referenced regulations are set forth in FAR 2.101 and FAR 7.107. In order to justify bundling, an agency must show that it would derive "measurably substantial benefits" and the benefits must be quantified. The regulation that addresses benefit further provides that the benefits may be deemed sufficient to justify bundling if the benefits to be derived from the bundling, after comparison with the benefits if requirements are not bundled, are equivalent to "(1) [t]en percent of the estimated contract or order value (including options) if the value is \$86 million or less; or (2) [f]ive percent of the estimated contract or order value (including options) or \$8.6 million, whichever is greater, if the value exceeds \$86 million." FAR 7.107(b). In addition, the regulation provides that "[i]n assessing whether cost savings would be achieved through bundling, the contracting officer must consider the cost that has been charged or, where data is available, could be charged by small business concerns for the same or similar work." FAR 7.107(g).

ITES-2S does not constitute consolidation under the regulations on bundling for reasons similar to those discussed in the context of the DFARS procedures on consolidation. Specific requirements are not pre-defined at the contract level under ITES-2S. Absent the identification of specific requirements, it is not possible to determine if requirements have been performed under separate smaller contracts. Nor is it feasible, in this situation, to quantify and compare the benefits from performing a bundled effort with the benefits from performing the "same or similar work" when not bundled.

Under the ITES-2S procurement, work will be specified at the task order level. The regulation expressly contemplates conducting a small business bundling justification for task orders. That is the appropriate time for the application of the bundling regulation in a procurement such as ITES-2S. Procedures are being finalized to ensure compliance at the task order level with the regulations governing small business bundling. The ITES-2S ordering guide and ASCP it-earn web site will both include notices that ordering offices are responsible for complying with the small business bundling regulation prior to the placement of an order under ITES-2S.

In addition, ITES-2S is not a bundled contract. FAR 2.101 defines "bundling" in terms of a solicitation that is likely to be "unsuitable for award to a small business concern." The ITES-2S procurement does not meet this regulatory standard. The procurement was determined to be suitable for performance by small businesses, and a number of small business concerns submitted proposals. Ultimately, awards were made to five offerors deemed to be small businesses by the SBA.

Even if the previous arguments that the requirements are not bundled are rejected, there is justification for the consolidation consistent with regulatory and GAO CICA bundling rules, based upon mission requirements. The objective of this acquisition is to provide a full range of services and solutions necessary for the Army to satisfy its support of the Army enterprise infrastructure and infrastructure goals for vital Command, Control, Communications, Computers, and Information Management (C4IM) services worldwide.

Since this objective includes obtaining end-to-end solutions support to satisfy worldwide development, deployment, operation, maintenance and sustainment requirements for C4IM services worldwide, these solutions must be uniform. Otherwise, operation, maintenance and sustainment of the systems, particularly where joint wartime operations are the norm, risk unacceptable disruption and delay. Having a single contract with a limited number of vendors is the best way to ensure this uniformity."

**Recommendation 2.** We recommend that the Director, Army Small and Disadvantaged Business Utilization develop a standardized contract review process for small business that verifies compliance with the Federal Acquisition Regulation requirements.

**Army Comments.** Concur. A standardized review process already exists to ensure compliance with the Federal Acquisition Regulation. For example, the Army Small Business Office participates on the Army Service Strategy Panel (ASSP) for procurements that exceed \$500 million. However, in accordance with your recommendation, the Army Small Business Office will develop a more robust review process to increase internal controls relative to proper NAICS code selection, bundling analysis, and a more in-depth review of the impact that major enterprise solution contracts may have on the small business community.

New procedures will add independent senior small business staff review on enterprise requirements, to be conducted prior to the review and strategy briefing with the senior procurement officials responsible for the strategy, solicitation, and award.

The Army Small Business Office will request that each Army ordering agency strengthen their internal controls to ensure strict adherence to the ordering guidelines relative to consolidating and bundling requirements.

Finally, your report identifies some contracts that contain similar requirements to those found in ITES-2S. The Army Small Business Office will request a review of alternative approaches to include those mentioned in your report, as we move forward with other enterprise/global contracts. The Army remains vigilant and committed to increasing participation and awards for small businesses to the maximum extent practicable. Your comments and recommendations are of significant value to the Army Small Business Program.



DEPARTMENT OF THE ARMY  
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17 JAN 2007

SAAL-PP

MEMORANDUM FOR OFFICE OF THE INSPECTOR GENERAL, DEPARTMENT  
OF DEFENSE, ATTN: MS. JACQUELINE L. WICECARVER,  
PROGRAM DIRECTOR, ACQUISITION AND CONTRACT  
MANAGEMENT, 400 ARMY NAVY DRIVE,  
ARLINGTON, VA 22202

SUBJECT: Information Technology Enterprise Solutions--2 Services Contracts  
(ITES-2S)

I am writing in response to your memorandum requesting that the U.S. Army delay award of the ITES-2S contracts due to issues identified by your office in a recent audit. Specifically, your memorandum expresses concern that the North American Industry Classification System (NAICS) code chosen for ITES-2S may have been incorrect. You contend that the chosen code "placed appropriately qualified small businesses at a serious competitive disadvantage," and that the issue may generate "further protests and litigation."

The U.S. Army awarded all of the ITES-2S contracts prior to receipt of your memorandum. Eleven awards were made on April 14, 2006, and an additional five awards were made on December 4, 2006. Thus, it is not possible for the U.S. Army to comply with your request to delay the awards. More fundamentally, though, the U.S. Army disagrees with your analysis of the NAICS code issue.

As noted in your memorandum, a contracting officer typically selects a NAICS code which best matches the work performed under the acquisition. This poses a challenge for large Indefinite Delivery, Indefinite Quantity vehicles such as ITES-2S, which are extremely broad in scope and have no defined requirements until individual task orders are placed. Quite simply, the U.S. Army can only make its best estimate as to what work will be performed under ITES-2S. Nor is there any single code that appropriately covers the complexity and the worldwide magnitude of the ITES-2S acquisition. In this circumstance, the U.S. Army's contracting officer made the most appropriate choice among various possible codes, selecting NAICS code 517110 (Wired Telecommunications Carriers).

The type of work performed under the acquisition is not the only consideration in choosing a NAICS code. Rather, the applicable regulations provide that "[o]ther factors considered include previous Government procurement classifications of the same or

similar products or services, and the classification which would best serve the purposes of the Small Business Act." Title 13 Code of Federal Regulations (CFR) Section 121.402(b). In the case of ITES-2S, these additional considerations support use of the chosen code.

Other similar procurements--such as the Air Force's Network-Centric Solutions (NETCENTS) contracts, the Communications-Electronics Life Cycle Management Command's Total Engineering and Integration Services (TEIS) I and II contracts, and the U.S. Army's predecessor to ITES-2S contract, ITES-1S--have all used the same NAICS code as was used for the ITES-2S contract. Although the Small Business Administration (SBA) size standard corresponding to NAICS code 517110 is larger than the standards associated with many other NAICS codes, the contracting officer's choice of NAICS code 517110 was appropriate and ultimately did not exclude smaller small businesses from participating in the acquisition.

The selected code's appropriateness was confirmed by ample market research. Based on that research, the ITES-2S contracting officer concluded that a NAICS code with a smaller size standard would have slanted the ITES-2S awards toward companies that were unable to "provide the depth/breadth of task areas required to meet enterprise requirements ... [and] manage large numbers of task orders."

By using the NAICS code of 517110, with its larger size standard of 1,500 employees, the U.S. Army chose a code that best described the principal nature of the services being acquired and permitted small businesses meeting the larger size standard to compete for contract awards. As proof that small businesses staffed to the larger size standard could perform the work, please note the fact that a total of five prime contracts have been awarded to small businesses that qualify under the 1,500 employee size standard. Although use of NAICS code 517110 permitted participation by small businesses meeting the larger size standard, without excluding other small businesses, no proposals were received from any small business that would have qualified under a more restrictive size standard, and thus no contracts were awarded to any such firms. Finally, the use of this code was approved by both U.S. Army and Department of Defense Small and Disadvantaged Business Utilization offices, as well as the SBA, prior to the issuance of the solicitation. Moreover, the Senate and House Small Business Committee staffs, were briefed on the selected NAICS code without a negative response.

You maintained that "Small Businesses that best met the purpose of the services to be acquired were forced to compete against businesses greater than seven times their size," and that the choice of NAICS code may result in "further protests and litigation." The U.S. Army disagrees with these assertions. In the course of choosing NAICS code 517110, the contracting officer concluded, in effect, that smaller small businesses did not best meet the purposes of the ITES-2S procurement. Although any small business,



regardless of size, could have submitted a proposal, the U.S. Army did not, in any event, receive any proposals from small businesses that would have qualified under a more restrictive size standard. Thus, there is no basis to conclude that smaller companies were placed at any competitive disadvantage. As any small business could have competed for the ITES-2S procurement, there is likewise no basis to conclude that there was improper bundling, or that a justification for bundling was required, in accordance with federal regulations. As a result, your assertion that "by not including legitimate small businesses in the award, ITES-2S is a bundled contract" is not well-founded.

Lastly, further litigation relating to the NAICS issue is unlikely. The choice of NAICS code is not a protestable issue. Rather, the forum that adjudicates such matters is the SBA. According to SBA regulations, any challenge to the Contracting Officer's choice of NAICS code must be raised within 10 days of the issuance of the solicitation. Title 13 CFR Section 134.304(a)(3). Absent such a challenge, "[t]he NAICS code assigned to a procurement and its corresponding size standard is final." Title 13 CFR Section 121.402(c). There was no challenge to the choice of NAICS code for ITES-2S, and the deadline for doing so has long since expired. Therefore, the NAICS code for ITES-2S became final, and not subject to further review, as of September 2005.

In sum, the U.S. Army is convinced that its choice of NAICS code was correct. The chosen code is not only a reasonable choice for the broad requirements that will be performed under ITES-2S, it is also consistent with the code selected for other similar procurements and supports the purposes of the Small Business Act by promoting small business participation. Finally, the time for challenging the choice of the NAICS code under the applicable regulations has expired.

  
Claude M. Bolton, Jr.

Assistant Secretary of the Army  
(Acquisition, Logistics and Technology)

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# Inspector General Department of Defense

